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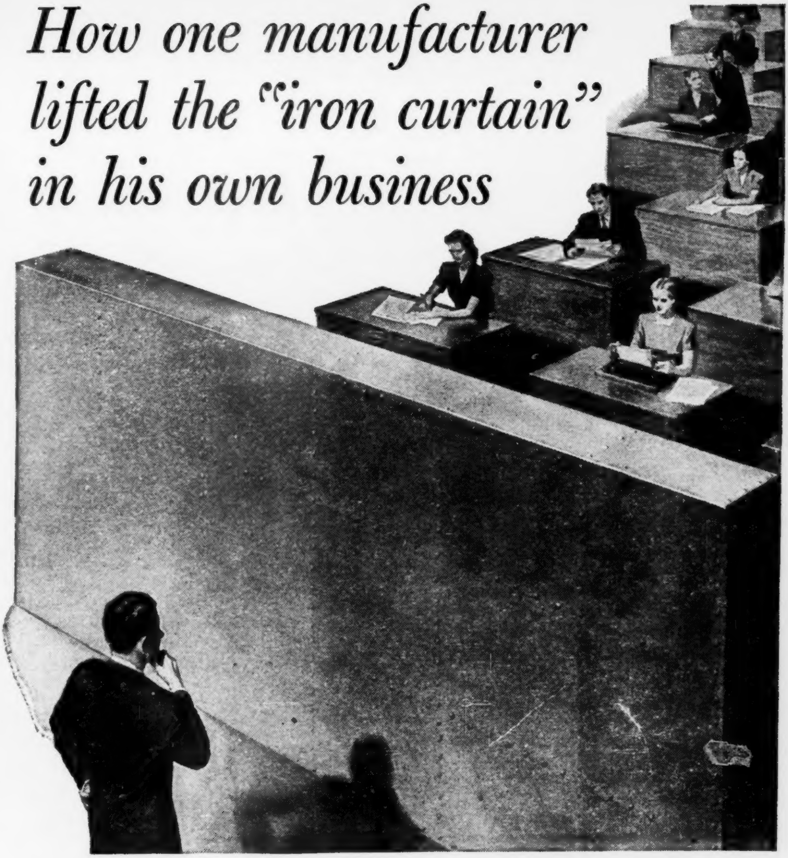

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CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

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Cost Accounting Research—The Road to Better Management

By THEODORE LANG, C.P.A.

COST research is only one of many lines of investigation now going on in every field of activity. We live in the age of the scientist and of the man who puts the scientist's theories to work—the engineer. To be sure, the true engineer covers many spheres of action. Among the older types were mechanical engineers, electrical, mining, and chemical engineers. But nowadays the term covers anyone who is trained in the applied sciences or who, on the basis of an individual survey, prescribes the installation of a special machine, accessory, gadget, or what-have-you. Included in this category must be the man who surveys a plant and recommends the installation of proper production and accounting controls—in short, the industrial engineer and his next of kin, the cost accountant.

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Before one can understand the contribution made by the individual engineer, it might be well to define research and study its nature. Research implies a search for the unknown and the formulation of a theory which would explain observed phenomena. The engineer's arena of action is more circumscribed. He takes a given theory and his job is to make it work, to put it to some practical use. This constitutes applied research activity. For example, chemical research may establish a theory concerning the nature of the molecular structure of natural rubber, and demonstrate that alcohol is one of the starting points in making synthetic rubber. The engineer then takes over and puts the theory to practical use. It is his job to discover the best source for the alcohol required; whether it is to be made from grain or from crude oil. In time this involves finding the answers to many questions, such as, the length of time for a manufacturing cycle, the equipment required, the availability of the raw materials, and the comparative costs of the various methods of production.

Definition of Research

All this implies that there are different kinds of research. Most people have the idea that research is something

mysterious, that it is practiced by a group of persons removed from the hurly-burly of everyday life, who putter around in a laboratory and finally achieve something whose applicability in improving our daily lives is highly problematical. Thus the late Steinmetz, of General Electric's House of Magic, used to amuse himself by hurling miniature thunderbolts around his laboratory. Yet this apparently useless activity has laid the basis for many useful inventions involving high voltage currents.

The fact is, most research is not of this basic type. To be quite blunt about it, and to connect it at once with the work of the accountant, every one engaged in accounting work does research work of one kind or another many times in the course of a year. Every time the chief hands out a special assignment and asks for a report, it involves a measure of research by investigating the facts and drawing the proper conclusions.

It is thus possible to draw up a definition of research. Research is a systematic inquiry calling for the assembling of facts, and their arrangement into a consistent pattern leading to a conclusion. This, in modified form, is the scientific method, made famous by the work of scientists in the nineteenth and twentieth centuries. It consists of a series of steps which include:

1. Observation of facts.
2. Formulation of a hypothesis, i.e., working theory to explain the observed facts.
3. A systematic gathering of additional facts, i.e., observed data, to see if they fit the hypothesis.
4. Conclusion in the form of a general statement.

Kinds of Research

Research is either inductive or deductive. In the former the researcher generalizes on the basis of specific cases. He works from known facts and formulates general statements which then apply to all facts of that type, both observed and unknown. The most familiar example is of course the story, many times disproved, of Newton's formulation of the laws of gravity, because a falling apple hit him in the head while he was taking a nap.

Deductive research establishes a specific fact from known general principles. The examples, most familiar to us, hark back to the days when we studied geometry. Once the proofs for certain theorems are accepted, these general propositions may be applied to a specific case to establish whether, in the instant case two lines *are* parallel, *perpendicular* to one another, etc.

In the field of cost accounting, the type of research being carried on is mostly of the deductive type. It is probably too early to formulate general cost accounting principles, except in the most superficial way. What the cost accountants in the field are doing is to adapt general accounting principles to the specific cost problems encountered. That is a deductive process.

Institutional Research

Research may be carried on either by institutions of one kind or another or by individuals. By and large, organized, that is, institutional, research tends to predominate these days, both in the physical sciences as well as in the professional fields represented by accounting, cost accounting, controllership, management, etc. In the physical sciences a tremendous amount of research is being carried on by individual enterprises. Because of their fame, it is fair to refer to them as institutions. They include the research laboratories of General Electric, Westinghouse, Eastman Kodak, etc. The list of those engaged in organized research activities would certainly include such additional institutions as the Research Bureau of the Harvard Graduate School of Business Administration and of various other universities such as Michigan, Ohio State, etc.

In scanning past activities in account-

ing research, we must not overlook the work done by various trade associations. These have been helpful in the development of uniform terminology for the particular industry, the development of uniform accounting systems, and in some instances of cost systems. They have also greatly aided report preparation, particularly where the trade association acts as a clearing house by collecting reports, digesting them, and publishing a yearbook or other publication which enables the reporting member to get an idea of where he stands in the industry by comparing his own figures against the figures, usually expressed as percentages, in the trade association publication.

Next, there is a group of certain semi-public institutions such as the United States Chamber of Commerce, the National Industrial Conference Board, Brookings Institution, etc. In this list, too, should be included various government agencies which have influenced accounting development both in peacetime and wartime. These would include a long list of agencies beginning with the Interstate Commerce Commission and other regulatory public utility commissions, the S.E.C., the Federal Trade Commission, and, of course, the Treasury Department, especially the Internal Revenue Bureau. During the war new concepts of cost were constantly being fostered by various government agencies including the Army, the Navy, and the Maritime Commission, which had a stake in accounting problems through renegotiation and contract termination.

Next in line is the work of various professional associations whose avowed aims include the study and dissemination of accounting knowledge. The list includes organizations such as the American Institute of Accountants, including its state affiliates consisting of the various state C.P.A. societies, the American Accounting Association, and the National Association of Cost Accountants.

All of us are familiar with the work done by the American Institute of Accountants. The Institute has put out two series of bulletins, one the *Accounting Research Series* and the other, the *Auditing Research Series.* In these bulletins the Institute has employed the deductive method; that is, on the basis of commonly accepted principles, it has tried to point out what would constitute acceptable practice in a specific case.

Other associations have also decided to develop research activities. Of these, the American Accounting Association, composed as it is mostly of college instructors, naturally enough undertook to do a limited amount of such research. It did this by encouraging the production of monographs. There have been a number of those—one on financial statements, one on corporate accounting standards, one on consolidated statements, and one on public utility depreciation.

All of this is perhaps no more than factual reporting. But it does constitute research of a factual or analytical type.

Work of the N.A.C.A.

It is into this framework that the N.A.C.A. stepped last year and decided to make a contribution to postwar readjustment by doing some research in its own field. Historically, this is an outgrowth of the work that had been carried on by the Association sporadically. Accordingly, a research committee was organized under the chairmanship of Dr. Thomas Sanders, and it started to function by suggesting a number of suitable fields in which research could be carried on. It was felt, however, that such hit-and-miss research was not likely to be profitable in the long run, that what was needed was a background of a general nature against which specific problems could then be set. The result was *Research Bulletin No. 7,* published May 15, 1946. It is entitled "The Uses and Classifications of Costs." Originally the committee was not at all certain that the information contained in this *Bulletin* should be

published. The material was gathered for the use of the committee as a guide in future research work; but when the text began to take shape, it was realized that it had an importance beyond the confines of the committee.

From the point of view of research in cost accounting, this paper marks a departure from previously accepted attitudes towards cost accounting. It brings into sharp focus the fact that cost accounting is used for a variety of purposes and that to meet these different objectives, different kinds of costs must be available. As cost accountants I realize that we may be criticized for the statement, but it is nevertheless a fact that the same thing *can* have different costs at the same time and all of them may be perfectly correct. The question "What does this cost?" is perfectly pointless. What is necessary for an answer to this question is a knowledge of what the cost is to be used for.

We have all had many experiences in this connection. During the war the cost of production was one thing in renegotiation; it was another thing in contract termination; it was still different in income taxation. Note particularly that no attempt has been made in *Bulletin No. 7* to define *cost* in the abstract. As far as the cost accountant is concerned, cost must be measured in relation to a defined purpose. We may safely leave it to the economist to speak of cost as an abstract proposition, as a thing in itself; but to the cost accountant the cost must always be attached to something definite, and the kind of cost that results can be stated only with respect to a given purpose.

Current Activity

Since the publication of *Research Bulletin No. 7,* the committee has felt encouraged to expand and branch out its activities. Now there are two ways in which work of this sort can be carried on. One can sit back in a library surrounded by the ghosts of the past and simply by thinking a given problem through, arrive at a conclusion. Some of the most notable contributions to the development of human thought and action have resulted from nothing more strenuous than armchair exercise.

Another type of activity is based on field research either through the use of interviewers or through questionnaires. This is the method being employed in carrying on the work of the committee.

Inventory and Period Costs

A careful reading of *Research Bulletin No. 7* points to several areas of cost accounting which need further exploration. One of these concerns the distinction between inventory or product costs on the one hand and period costs on the other. When we charge anything to inventory, we are in effect capitalizing the charge. That term is not ordinarily used in connection with current assets; nevertheless, the principle is very much the same, since the charge to inventory, like the charge to a capital asset, defers the amount to a subsequent period or periods and is, therefore, during the life of the asset, carried on the balance sheet. The moment, therefore, an item is to be included on the balance sheet, the financial accountant immediately begins to worry about a basis of valuation. The general rule of valuation, "the lower of cost or market," is small comfort to us, since it does not tell us which cost is to be used. There are those staunch believers in standard costs who are perfectly content to have the inventory shown on the balance sheet at the standard cost, on the theory that this is a better cost than an actual or accidental cost. There is another school of accountants that believes in the use of actual costs for inventory values, but that is far too vague a proposition. First, there is the question of whether we should use a first-in first-out cost or some kind of average cost. All of these may be considered as actual costs. But we have to go more deeply into the question and decide what items make up

the cost of raw material and of other inventories. For example, are such things as transportation charges, customs duties, receiving and handling charges, etc., to be considered as part of the cost of the material, or are they to be written off against the period in which such costs were incurred? Again, both in the case of raw materials and goods in process, shall we consider general administrative overhead as applicable in part to inventories? It obviously makes a difference in our inventory valuation and, therefore, in our profit and loss statement whether we include all or a portion of these charges in inventory or whether we treat them as purely nominal items—that is, as period charges to be written off at the end of a given fiscal or cost period. At the moment the Association has done a certain amount of field research and has supplemented it by the use of a questionnaire to provide information on this interesting and important topic.

Wartime Problems

On June 1, 1945, the Association put out *Research Bulletin No. 5* dealing with accelerated amortization under certificates of non-necessity. This was for the most part a matter which involved taxes and procedures for a particular company from the point of view of our tax laws. It was followed on January 1, 1946, by *Research Bulletin No. 6* dealing with the accounting problems arising from tax amortization of emergency facilities. As the title indicates the accounting problems were stressed and the committee set forth, without taking any position, the different ways in which the amortization of the emergency facilities could be handled. Several methods were presented together with their advantages and disadvantages, again without taking any position in favor of or against any one method. The result has been *Research Bulletin No. 8* published November 15, 1946, entitled "Postwar Practice in Accounting for Emergency Facilities." This is purely a factual report as to what different companies have done in accounting for the wartime emergency facilities.

These wartime problems, remote from reality as they may seem at the moment, nevertheless produce food for thought in our peacetime activities. For example, the accounting treatment and the related tax treatment for wartime facilities must lead the thoughtful student of the subject eventually to inquire as to the practice followed in peacetime in accounting for fully depreciated or fully amortized assets. True, we have had a number of general statements by textbook writers and others in this connection. Most of these statements have approached the problem from a financial point of view and from the point of view of the proper reporting of income in an operating statement. In other words, the point of view of the public accountant, the financial accountants, and the tax accountant have dominated the picture in this respect. It is time the question was raised from a cost accounting point of view: "What should the treatment be?" This is something, then, to which we may look forward as one of the things that is scheduled to be undertaken in the future and which will provide us with facts based on careful study which we may use in our work of educating management to take advantage of the work of the cost accountant.

Practices in the Use of Material and Labor Standards

One of the papers projected has to do with recent trends in cost practices—particularly the application of standard costs. As everyone knows, the war set back cost accounting to the point where it is necessary to re-educate the business community—a job that was pretty well under way by 1939. So many things have happened, however, during the war years that it is necessary to do this job all over again. It is to make management in general cost-conscious that the accountant must have ammunition at his disposal. It is these

research projects which provide that ammunition so that the wide awake cost accountant can apply it in furthering the aims of management and bring them into harmony with the more specific aims of the cost accountant.

Hence, one of the subjects now being explored by the N.A.C.A. research committee is the practice followed by different companies in the use of material and labor standards and the effect of the various uses on the development and application of standards. Our purpose is to determine how companies use standards for such purposes as inventory valuation, cost control, budgeting, pricing, production planning and control, etc. We also would like to know which of these uses predominate and which are secondary, and the effect of these uses on the "tightness" or "looseness" of the standards set. In this connection, we would like to determine the extent to which standards are developed to satisfy a primary need and how they are modified or adjusted to meet the other purposes. Finally, we are asking the cooperating companies to give us a statement showing how the war affected standard costs in their company and also the uses to which the standards, if any, were put.

From the answers obtained thus far, it is amply evident that nothing startlingly new has been produced in the way of cost control practices. At the moment much effort is expended in trying to regain ground lost during the war. Before the war, good "cost control practice" included:

"In summary, it may be said that good cost control practice in the period before the war involved:

1. The classification of costs in terms of:
   a. Nature of expenditure
   b. Responsibility
   c. Variability
2. The predetermination of planned or standard costs and budget allowances.
3. The accumulation of actual costs.
4. The comparison of actual costs with standard costs and budget allowances in order to determine what variations had occurred and the causes of these variations.
5. The prompt reporting of variances to those individuals having authority to incur costs.
6. Managerial action to eliminate unfavorable variances when actual costs differed from standard costs or budget allowances."

During the war the emphasis was on production without regard to cost, there was a lack of incentive to maximize profits; there was an emphasis on cost finding for reimbursement purposes, to the detriment of cost for control purposes. All these were, of course, aggravated by a shortage of personnel.

What does the post-war picture hold in store for us? A survey of answers obtained points to three areas of improvement:

(1) Improvement of technical proficiency;

(2) Improvement of reports and their interpretation;

(3) Selling, cost control to various levels of supervision.

Under improvements of technical proficiency, the following may be listed:

(a) Review and revision of accounting classifications to conform to present organization setups.

(b) Revision of material and labor rate standards to reflect current price levels. However, prewar labor performance standards are in many instances retained even though current performance is below standard.

(c) Revision of normal overhead rates to reflect substantially higher activity levels than prevailed in the thirties.

(d) Simplification of accounting routines, especially elimination

of repeated allocations and distribution.

(e) Greater mechanization of clerical operations.

(f) More extensive use of forecast and flexible budgets especially the former for long range knowledge of plant additions, replacements, capital requirements.

(g) Increased use of standards expressed in terms of physical units.

Under improvement of reports may be listed the following:

(a) Recognition of the need for designing reports for the specific uses to which they are to be put;

(b) Speeding up the preparation of reports;

(c) Emphasis on staff help to executives by interpretation of reports and thus obtain prompter action;

(d) Cost department to provide special analyses, reports, and suggestions, with respect to replacement, additions, products, prices, selling methods. These involve the use of special purpose costs;

(e) Selling cost control throughout the organization by an educational campaign.

Individual Research

So much for organized research on the institutional level. There still remains the problem of work that is so restricted in its applicability that it must be done by an individual. Here we find the problems that are nearer to us because they affect our daily work. We may be asked to report why there is a big increase in scrap in Department A, or what would be the effect on the cost of production if machine speeds in Department X were increased 15%, or whether there is a possibility of improving the accounts payable technique. Note, however, in each case it is a question of pinpointing a problem that is of immediate concern to a particular company. Suppose, for example, we wanted to find out whether it paid the company to increase the speed of machines in a certain department. What it boils down to is a study in comparative costs before and after the speed increase. If we use the experimental method we would take one or more machines under observation, measure the speed, the output, rejects, number and extent of machine interruptions, reasons for these interruptions, such as tool breakage, overheating of machine, inability to feed the machine properly at the increased speed, etc. We would gather all these statistics for machines running at normal speed and those machines operating at the increased speed. At the increased speeds, we get, of course, more spoilage, more tool breakage, more depreciation, etc. It is now our job to balance the costs against one another to see if the speed increase is warranted financially.

A second group of problems calls for changes in existing methods. For example, simplification of procedures, such as payrolls, accounts payable, processing customers' orders, billing, etc. In this connection a great deal may be accomplished by attempting to coordinate different procedures into a unified whole, especially by producing different records in a single writing, or by improving the internal routines.

Special Purpose Costs

We now come to the third and most important group of problems. They lie in the relatively unexplored area of special purpose costs. It is almost certain that as time goes on, the real work of the cost accountant will tend more and more to be in the field of developing special costs for special purposes. After all, the first two groups of problems mentioned above are merely putting the accountant's house in order; the last group involves problems of top management, problems which arise because the individual busi-

ness is after all part of the national economy. They are the problems which reflect the impact of forces external to the business. Among these we find the problems of whether to buy or manufacture parts, to take on business at less than average cost, to shut down or operate at a loss. Or again, the question may involve the advisability of a general price cut and how many more units will have to be sold to leave the company as well off, profitwise, as before the price cut.

These problems arise for the most part because of the presence of fixed assets and their continuing burden of fixed charges. They are serious during the next few years. As labor rates go up, more and more automatic machinery will take the place of manual labor. But this is far from an ideal solution; the introduction of more machinery pushes the break-even point to higher levels, so that the safety margin of the business steadily shrinks. To these problems the cost accountant can provide at least partial answers. But they are essential answers in enabling management to arrive at a proper policy.

It is evident therefore that the cost accountant's field of inquiry, that is, the scope of his research, will take him into every activity where costs are needed as a basis for managerial action. In other words, the uses of costs, in all their variety, constitute the fundamental area in which research will be carried on.

"The principal purpose in the minds of management when it establishes an internal auditing department is to assure itself that the accounting activities of the company will be subjected to sufficient scrutiny and test checks to determine if the accounting records are correct and properly present the financial condition of the company as of a given date and the results of its operations for a specified period of time. The management also expects the auditing activities to disclose any deviation from company policies and procedures which may have occurred during the compilation of the records, such as the failure to take cash discount on purchases, the proper provision for depreciation, depletion or obsolescence of fixed assets, and the necessary provision for other reserves."

Internal Auditing and Public Accounting
As Training for Administrative Personnel

By Robert R. Crawford
in Spring, 1947, issue of The Ohio C.P.A.

A Comparison of the Principal Features of the Federal and New York State Personal Income Taxes

By H. E. Bischoff, C.P.A.

Although Article 16 of The Tax Law of the State of New York, dealing with the income tax on individuals, estates and trusts, is patterned after the Federal Internal Revenue Code, there are marked differences in certain essential features.

Unless the tax practioner is conversant of these variances, which are expanded or reduced from time to time as new legislation is passed by either Congress or the State legislature he may find to his embarrassment that he should have treated certain items differently in the New York tax return than in the Federal return.

For obvious reasons it will not be possible to cover, within the limits of this article, all the differences between the two laws. For that reason an attempt is made to confine the discussion to some of the more essential features of both laws.

Some of the tax services dealing with the New York Personal Income Tax furnish a comparative chart of the Federal and New York laws.

Harold E. Bischoff, C.P.A., with Lybrand, Ross Bros. & Montgomery, was formerly an instructor at Columbia University.

He is a member of the Society and of its Committee on State Taxation.

This address was delivered on March 25, 1947, at the meeting of the Society devoted to a consideration of the New York State income tax.

Gross Income

Salaries and Compensation: Salaries, wages, fees, etc. are in general taxable under both laws. This rule also applies to all federal, state and municipal employees. The special treatment under Sec. 107 (a) of the Federal Code of compensation for personal services rendered covering a period of 36 months or more, under which the taxpayer has an option so that the tax shall not be greater than the aggregate of the taxes which would have been paid if such amount had been included in gross income in each of the years included in the period, is not allowed under the State law.

Interest: Interest on farm loan bonds under the Federal Farm Loan Act on Treasury Bills and Certificates of Indebtedness and on U. S. Bonds and Treasury Bonds issued prior to March 1, 1941 is exempt in whole or part from Federal income tax whereas interest on U. S. obligations issued after February 28, 1941 is subject to Federal tax. For New York State tax purposes interest on obligations of U. S. or its possessions or instrumentalities, whether issued before or after March 1, 1941, is exempt from tax. For both Federal and State tax purposes the interest on obligations of New York State or any political subdivisions thereof is exempt but interest on obligations of states and political subdivisions thereof other than New York is subject to New York tax but exempt from Federal tax. The taxpayer is required to report any nontaxable income in a special schedule

provided therefor on the New York tax return (Schedule 7, page 2, Form 201).

Under a recent revision of the regulations the State procedure has been made to conform with the amendment of the Treasury regulations after years of unsuccessful attempts to tax the increment over face value of amounts received under a life insurance policy paid in instalments rather than as a lump sum, by reason of the death of the insured. For both Federal and State purposes both lump sum and instalment payments of life insurance proceeds are now tax free. If, however, the proceeds are held by the insurer under an agreement to pay interest, the interest is taxable.

Dividends: Received in cash or property are generally taxable under both laws. As to dividends received on stock, i.e. stock dividends, for Federal purposes these are treated as taxable unless such distribution cannot be taxed under the Sixteenth Amendment to the Constitution, e.g. where the dividend results in no change of the proportionate interest of each stockholder in the earnings or assets of the corporation. For State tax purposes stock dividends are exempt and the tax basis of the stocks on which the dividend was received must be adjusted.

Other Income: Recovery of bad debt deductions are excluded from gross income to the extent that the prior deduction did not result in an income tax benefit in any previous year for Federal purposes, whereas the State limits this exclusion to bad debts charged off and deducted in a taxable year not more than three years prior to the year in which the recovery is made.

Others types of recoveries are not specifically covered by the New York law and it would appear that a taxpayer may not take advantage of the "tax benefit rule" provided for Federal purposes, e.g. recoveries of taxes, losses, expenditures and accruals other than depreciation, depletion, amortization and amortizable bond premiums (Sec. 29.22 (b) (12)-1 Reg. 111).

Deductions

Expenses-General: Such expenses if incurred in business, in production or collection of income or in connection with income-producing property are allowable deductions for both Federal and State tax purposes.

Taxes: For the New York return the taxpayer may deduct all Federal taxes except federal income, estate and gift taxes. The Federal return does not allow after December 31, 1943 the deduction for Federal import duties, excise and stamp taxes except where such taxes fall in the category of business expenses. Some of the variances in the taxes allowed as deductions under the two laws are summarized below:

(1) New York State stamp transfer tax on security sales allowed as a tax deduction reducing normal income for Federal purposes but applied against the proceeds received affecting the capital gain or loss for New York purposes.

(2) New York State income and unincorporated business tax allowed as deduction for Federal but not for State tax purposes.

(3) Income taxes of states other than New York allowed as deduction for Federal but not for State tax purposes.

(4) Federal excise taxes not proved to be business expenses not allowable deductions for Federal purposes but allowable for State, e.g. Federal tax on admissions, telegraph, telephone, safe deposit box, etc.

Credit for Taxes Paid: Where a nonresident is subject to tax in the state or country where he resides he may credit against the tax on net income and capital gains payable in New

York a proportionate part of the tax payable thereto provided such state or country has a similar reciprocal law or taxes its residents without taxing residents of New York.

Under the recent treaty with Great Britain (T.D.5532) dividends received U. S. taxpayers from British sources as to which tax has been withheld may be reported in the Federal return as income for the gross amount and the tax, with certain limitations, claimed as a credit against the U. S. tax or the dividends may be included in taxable income for the net amount, whichever is more advantageous.

For New York State purposes the taxpayer may not claim the credit against the tax but must report the net amount (gross dividend less standard tax) as taxable income.

As to dividends received from Canadian corporations the gross amount of the dividend must be reported without deduction of the Canadian tax for State tax purposes although such taxes may be claimed as a deduction or credit for Federal purposes.

Losses: In general losses incurred in trade or business, in transactions entered into for profit and from fire, storm, shipwreck, theft or other casualty are allowed under both laws. There are no provisions in the State law similar to the Federal provision disallowing losses (1) between members of the family or family controlled corporations termed "in the family transactions" and (2) from sales of securities where within a period of 30 days identical securities were acquired termed "wash sales".

As a result of the Tax Court decision in Leland Hazard (7 T.C.372) it appears that the Treasury has receded from its previous position and now allows as an ordinary loss, instead of a capital loss, the loss on sale of real estate leased or rented by the taxpayer notwithstanding that his chief vocation is other than real estate, e.g. lawyer. The State Tax Commission has not fallen in line with the Treasury in this respect and is still holding that such losses do not affect income subject to normal tax. Loss on sale of residence not allowed for Federal purposes but treated as capital loss for state purposes.

Losses on worthless securities are deductible as capital losses and not ordinary losses under both laws.

The net operating loss carry-overs and carry-backs provided under the Federal law are not provided for in the State law so that if the taxpayer sustains a business loss in one year the tax advantage of applying that loss against the profits of another year, with certain limitations, cannot be availed of.

Whereas the basis of recognition of loss is cost or adjusted basis without reference to March 1, 1913 value in the case of the Federal return for New York purposes if the asset was acquired prior to January 1, 1919 the basis is cost or fair market value as of the latter date, whichever is lower.

Bad Debts: Worthless bonds are classified as capital losses not as ordinary deductions under both laws. The Federal provision that losses from nonbusiness debts shall be treated as short term capital loss has no equivalent in the New York law so bad debts arising out of personal loans may be taken as ordinary deductions in the State return.

Depreciation and Depletion: Whereas the basis for depreciation and depletion as to property acquired prior to that date is fair market value at March 1, 1913 for Federal tax purposes the fair market value at January 1, 1919 is the basis used for State tax with respect to property acquired prior thereto.

Amortization of War Facilities: Whereas amortization of war facilities allowable under Section 124 of the Code is also allowed for State purposes, the State Tax Commission has announced that amortization recomputed on the shortened period, based on the termination of the emergency period by the President as of Septem-

ber 29, 1945, and as to which a tentative adjustment has been made (Form 1140) will not be allowed for State tax purposes until the Federal returns, revised to give effect to such amortization, have been examined and approved by the Treasury.

Life Insurance: A deduction allowed for State and not Federal tax purposes, and one which is often overlooked, relates to the life insurance premiums paid on any life insurance or endowment policy upon the life of the taxpayer not in excess of $150. Where an employee, under a company group insurance plan, pays a part of the premium such payment should be included in the deduction claimed by him in his personal return.

Contributions: The 15% limitation on charitable contributions for Federal purposes is now computed on the adjusted gross income, i.e. income before applying other than business deductions shown on page 3 of the return, whereas for State tax purposes the 15% limitation is applied to net income after applying all deductions except those for (a) contributions and (b) medical expenses (Item 16, page 1, Form 201). It would seem that in order to encourage more or larger contributions of this nature the State might fall in line with the Treasury in this respect since under the present procedure the allowable contributions may be considerably less for State tax purposes where the non-business deductions of the taxpayer are consequential.

Extraordinary Medical Expenses: As in the case of contributions the limitation on these deductions is computed differently under each law. In the Federal return the 5% limitation is applied to the adjusted gross income (Item 6, page 1 of Form 1040) and the deduction is further limited to (a) $2,500 if more than one exemption is claimed or (b) $1,250 if only one exemption is claimed. In the State return the 5% limitation is applied to net income before this deduction (Item 18, page 1, Form 201) and is further limited to (a) $1,500 where husband and wife file a joint return or the head of a family exemption is claimed and (b) $750 in the case of all other individuals). This usually results in a lesser allowance under the State law since the deductions other than business deductions do not reduce the base to which the 5% limitation is applied for Federal purposes.

Optional Standard Deduction, etc.: The $500 special deduction for the blind, the optional standard deduction of $500 in case of income of $5,000 or over and the computation of the tax under the optional tax table (Supplement T) provided under the Federal return have no counterpart in the State law.

Capital Gains and Losses

The distinction between long-term and short-term capital gains and losses under which certain percentages are taken into account depending on the holding period of the property sold and the allowance of $1,000 of a capital loss deduction as a deduction from other income for a five year period under the Federal law are not followed by the State. In the latter return capital gains and losses are computed separately, net capital losses are deductible from capital gains only and net gains are taxed at ½ the rate imposed on other income instead of 50% of the recognized net gain alternative method followed in the Federal return.

A net capital loss in any taxable year beginning on and after January 1, 1942 may be carried forward and deducted from net capital gains only for the next five years.

In computing the tax on net capital gains no exemption is permitted unless the other net income is less than the personal exemption in which case the amount of exemption unused in computation of the normal tax may be offset against net capital gain.

Basis for Determining Gain or Loss

In place of using the March 1, 1913 value the State law uses January 1, 1919 value or cost whichever is higher in determining gain, and cost or fair market value on that date whichever is lower in determining loss on the sale of property acquired prior to January 1, 1919. No gain or loss results where amount realized falls between cost or January 1, 1919 value. As to property acquired subsequent to December 31, 1918 cost or last inventory value is used.

As to property acquired by gift prior to December 31, 1927 (in place of the Federal date December 31, 1920) the basis is fair market value when acquired. As to gifts acquired after December 31, 1927 the basis is the same as it would be to the donor or last preceding owner not acquiring by gift except that if a loss results the basis used is the former or value at time of gift whichever is lower.

As to property acquired by inheritance devise or bequest generally the basis for determining gain or loss is the fair market value at date of death, e.g. the amount reported for estate or inheritance tax purposes.

Personal Exemption and Credit for Dependents

For Federal purposes the exemption is $500 for the taxpayer, $500 for his wife (or her husband) and $500 for each dependent relative. The head of a family classification no longer applies. The status at the end of the year governs as to whether or not individuals are married except where a spouse died during the taxable year. For State purposes a single person or a married person not living with husband or wife during the entire taxable year may claim $1,000, husband and wife living together during the entire taxable year and a person who was head of a family may claim $2,500. If husband and wife file separate returns the exemption may be taken by either or divided in the most advantageous manner.

A $400 exemption may be claimed for each person (other than husband or wife) under 18 years of age, or incapable of self support or in full time attendance at college receiving his or her chief support from the taxpayer.

If the exemption status of the taxpayer changes during the year the exemption is apportioned to the number of months before and after such change.

The exemptions for Estates and Trusts are $1,000 each for State purposes whereas the Federal Code allows $500 to the former and $100 to the latter.

Rates of Tax

Individual Rates: The Federal tentative normal tax rate for 1946 was 3% and the tentative surtax rates applied at graduated rates increasing from 17% on surtax net income not over $2,000 to 88% on surtax net income over $200,000. The total tentative normal and surtax was reduced by 5% to arrive at the final tax.

The New York tentative normal tax rates on net income exclusive of capital gains follow:

	Rate of Tax
$ .01 to $1,000......	2%
1,000 to 3,000......	3%
3,000 to 5,000......	4%
5,000 to 7,000......	5%
7,000 to 9,000......	6%
All over 9,000......	7%

As a result of recent legislation the tax computed at the above rates is subject to a 50% reduction on the total amount of tax due for 1946.

There is no surtax under the State law.

As stated above capital gains and losses are computed separately and the tax on net capital gains is computed at one half the normal tax rates. This total tax is also reduced by 50% as a result of recent legislation.

Administration

Who Must Make a Return: A New York State return must be filed if the

total net income and net capital gains equals or exceeds (a) $1,000 if single or married and not living with spouse during entire taxable year (b) $2,500 if married and living with spouse during entire year (c) the personal exemption allowable if taxpayer was married and living with spouse during only part of year, or if the total gross income and capital gain from all sources is $5,000 or over.

If a taxpayer during the taxable year changes his status from that of resident of New York to nonresident, or from nonresident to resident he must file two returns, one as a resident covering the part of the year during which he was a resident, and one as a person other than a resident covering the part of the year during which he was a nonresident. The exemptions are divided ratably between the two returns according to time. However if two returns for one taxable year are filed the taxes due thereon shall not be less than would be payable if the total net income and net capital gain shown by the two returns were included in a single return.

The filing of Withholding Statement Form W-2, or the first page of Form 1040 and calculation of tax under the tax table shown on page 4 (Supplement T), permitted under certain conditions (income less than $5,000 etc.), as an alternative to the completion of pages 1 to 3 inclusive of Form 1040 for reporting net income for Federal tax purposes can not be followed for State purposes. However Optional Form 200 may be used in place of Form 201 to report income from only compensation as employee, pensions, annuities, dividends, interest, partnership, estates or trusts.

Filing Date: New York returns for the calendar year 1946 must be filed with the State Tax Commission, Income Tax Bureau, at The Governor Alfred E. Smith State Office Building, Albany 1, New York, or at one the district offices listed on page 4 of Form 201 on or before April 15, 1947. Returns for any other period must be filed on or before the 15th day of the fourth month following the close of the period.

Dates of Payment: The tax may be paid at one time, when return is filed, or in four instalments, ¼ on filing return, ¼ on or before 3 months, ¼ on or before 6 months and ¼ on or before 9 months after due date of return. Only the last instalment may be less than $5.00.

Period of Limitation: For assessing additional tax is the same under both laws (a) 3 years after return is filed (b) 5 years if more than 25% of reported income is omitted and (c) no limitation if no return filed or return filed is false or fraudulent.

Where in any taxable year a deduction is disallowed which would have been allowable in a taxable year not more than five years prior thereto, notwithstanding any other limitation of time the State Tax Commission may revise the return and resettle the tax for such prior year by allowing such deduction and allow such overpayment as a credit in an amount not in excess of the related assessment in the taxable year.

Refund Claims: Application for revision or refund in a form prescribed by the Tax Commission may be filed within two years from the time of filing the return or if the tax has been recomputed or an assessment made where no return filed then within one year from time of such recomputation or assessment.

A Digest of the Unincorporated Business Tax

By FRANK E. KNOPF, C.P.A.

History and Scope of the Tax

THE New York State Unincorporated Business Tax is an income tax. It was enacted by the State Legislature as a temporary measure in 1935. It originally levied a tax of 4% on the net income of any unincorporated trade, business or occupation, wholly or partially carried on within the State of New York, by either residents or non residents.

The law has been extended each year since 1935, and the last extension covers the calendar year 1946, or any fiscal year ending in 1947.

The law initially imposed a tax on the net income earned for the calendar year 1935, or any fiscal year ended in 1936. Chapter 110 of the Laws of 1946, effective March 12, 1946, reduced the rate of tax from 4% to 3% for the calendar years 1945 and 1946, or fiscal years ended in 1946, and 1947. This would preclude the applicability of the reduced rate to a fiscal year or a short year ended before December 31, 1945.

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Prior to entering public practice, he was a member of the staff of the Special Investigations Bureau of the New York State Department of Taxation and Finance and, also, Assistant Chief Accountant with The Workmen's Compensation Investigation (1943), and with the Albany Investigation (1944). He is now practicing public accounting as a partner in the firm of Knopf and Raeman, C.P.A.'s.

This address was delivered on March 25, 1947, at the meeting of the Society devoted to a consideration of the New York State income tax.

Accounting Methods

The law permits for the use of either the cash or accrual method of accounting and the taxpayer must, for purposes of this tax, follow the method he used for reporting for income tax purposes. A change cannot be effected without the approval of the State Tax Commission. Either a calendar or fiscal year basis is permitted and there, too, it must be in accord with the method used for reporting for income tax purposes. Similarly, this cannot be changed without the approval of the Commission.

Gross Income Defined

All gains, profits and income derived by an unincorporated business, including profits from sales of real or personal property, rents, dividends, commissions, brokerage fees, or gains and income derived from any source whatsoever, connected with the carrying on of an unincorporated business, are includible in gross income.

Generally, all items of income includible in gross income for income tax purposes, if and to the extent that they are connected with a trade or business carried on within New York State, are also includible for unincorporated business tax purposes.

Exemptions from Gross Income

Exclusions from gross income subject to unincorporated business tax are generally the same as those for income tax purposes. The principal items are:

1. Interest upon obligations of the United States or its possessions or the obligations of the State of New York

or of any municipal corporation or political subdivision of the State of New York.

2. Proceeds of life insurance policies paid, by reason of the death of an insured.

Deductions from Gross Income

Deductions allowable from income, subject to the unincorporated business tax are, in the main, the same as those permitted for income tax purposes. While the same items are permitted for both the income tax and the unincorporated business tax, the amounts may vary because of the different basic dates. The income tax law was promulgated on January 1, 1919, while the unincorporated business tax law became effective on January 1, 1935. Deductions from gross income, allowable under the unincorporated business tax law, are:

1. All ordinary and necessary business expenses paid or incurred during the year in the carrying on of an unincorporated business.

2. All interest paid or accrued during the taxable year, except interest accrued on a debt secured by a lien on real property or a leasehold which is paid solely by being applied or credited in satisfaction of a bid by the creditor on a sale held for the enforcement of such lien. Note that this interest is not taxable to the creditor.

3. Taxes other than estate, inheritance, legacy, succession, gift and income taxes, paid or accrued within the taxable year, imposed by the United States or any of its possessions, or by the authority of any state or territory or taxing subdivision, or by the authority of any foreign government.

4. Losses, not compensated by insurance, if connected with a trade or business.

5. Bad debts, ascertained to be worthless and charged off within the taxable year or, in the discretion of the Tax Commission, the reasonable addition to a reserve for bad debts. In the case of a debt existing on January 1, 1935, the value of such debt, as of that date, would be allowed as a deduction. A worthless debt, arising since January 1, 1935, income from which was not previously taxed under this Article, would not constitute an allowable deduction.

6. Depreciation—a reasonable allowance for the exhaustion, wear and tear of property used in a trade or business —includes amortization of war facilities covered by Certificates of Necessity issued by the Secretary of War or Secretary of the Navy, applicable for years commencing on or after January 1, 1940. The January 1, 1935, value may be used for property acquired prior to that date.

7. Depletion—the basis for an allowance for depletion is the January 1, 1935, value of the property if it was acquired prior to that date. The percentage of depletion allowed on oil and gas wells is 27½%. In the case of mines and timber tracts, a reasonable allowance for depletion is permitted, based on the peculiar conditions existing in each case. Depletion on mines, discovered after January 1, 1935, and not acquired by purchase of a proven tract, where the fair market value is disproportionate to the cost, will be allowed on the fair market value of the mine at the date of discovery, or within 30 days thereafter.

8. Contributions may be deducted only if and to the extent that they were made for business purposes. Such contributions are limited to 15% of the net income before such deduction.

Recognized Professions

The following professions are specifically excluded from unincorporated businesses, subject to the tax: law, medicine, dentistry and architecture. These, under existing state law, cannot be conducted as corporate entities.

The regulations further recognize other professions where more than 80% of the gross income is derived from per-

sonal services actually rendered, and in which capital is not an income-producing factor. The State Tax Commission, by virtue of this definition, has also exempted the following professions from the tax imposed by this article: accountancy, certified shorthand reporting, chiropody, dental hygiene, engineering, optometry, osteopathy, pharmacy, physiotherapy, teaching, veterinary medicine, and surgery.

Income realized from a profession, wherein capital is not an income-producing factor, will be deemed to have been derived from personal services rendered, even though assistants are employed to perform part of the work, provided that the work of such assistants is closely supervised. It is essential that in the general conduct of the profession, the principals consult with clients, attend conferences, and prepare outlines and work programs to be followed by the assistants.

The use of capital in a professional entity will not be considered as a material income-producing factor, if it is used only to pay current operating expenses, such as salaries of assistants, rent and other incidental office expenses, or for the investment in furniture and equipment essential to the carrying on of the professional activity.

There has been some litigation on the question of what constitutes professional endeavor, and, of the nine cases decided by the courts, only two occupations, one, a landscape architect and the other, an industrial engineer, were recognized as professions, as defined by Article 16A. The court, in both cases, stressed the fact that colleges confer degrees upon the completion of courses of study in these fields. These cases are:

Geiffert v. *Mealey,* 293 N. Y. 583 (1944); reversing 267 A. D. 681 (1944).

Teague v. *Graves,* 261 A. D. 652 (1941); affirmed, no opinion, 287 N. Y. 549 (1941).

The question is generally a complex one. The State Tax Commission has recognized authors as practicing a profession, by reason of an old English law which recognizes journalism as a profession. Also, well-known dance orchestras, commonly referred to as "name bands", have been given professional recognition, to the exclusion of the lesser known orchestras.

More recently, a "labor consultant" was accorded professional recognition by the Commission on the ground that degrees were being conferred by a college in the State of New York, based upon a course of study in labor relations.

Those following highly specialized vocations, and desiring immunity under this Act, will undoubtedly have to continue to litigate their cases.

Where business is carried on simultaneously with the practice of a profession, income derived from the conduct of the business, is not exempt from tax under this Article. It is essential, where such dual activity exists, that the income from professional services be segregated. Thus, an optometrist must segregate the charge of his examination from the charge for the glasses he prescribes if he is to avoid the imposition of the unincorporated business tax on his professional income. Expenses of doing business must also be apportioned between the professional and non-professional activity.

Trader vs. Dealer

The question of the applicability of the unincorporated business tax law to traders in securities, commodities or real estate, was most controversial until its clarification by an amendment to Section 386 of the Tax Law, by Chapter 554 of the Laws of 1944, applicable to taxable years beginning on or after January 1, 1943.

Prior to this amendment, the trader, engaged in the purchase and sale of securities or real estate for his own account, was subject to the tax if, in the opinion of the Tax Commission, his trading was of sufficient frequency,

regularity and continuity, and if he devoted the major portion of his time and energy to the carrying on of this activity.

A distinction is made, however, in the instance of an individual or partnership engaged in an unincorporated business, receiving income from assets directly or indirectly connected with its trade or business. Such income is subject to tax under this article. Similarly, gain or loss from the sale of these assets would come within the purview of this act.

An amendment to the law, retroactive to the year 1936, excludes from the definition of an unincorporated business "the mere holding, leasing or managing of real property by an owner, lessee or fiduciary".

The dealer in securities, commodities or real estate, on the other hand, usually carries an inventory which he offers for sale to customers. He is deemed to be engaged in an unincorporated business.

Employee vs. Independent Contractor

It is not intended that an individual shall be deemed engaged in an unincorporated business with respect to compensation received by him for services rendered as an employee, officer of a corporation, or as an employee of a state, municipality, or political subdivision of a state, or as an executor, administrator, receiver, trustee, liquidator, referee, assignee, or other fiduciary, unless such compensation constitutes receipts from a business regularly carried on by such person.

Where, under the terms of employment, an individual operates his own office or place of business, employs his own assistants or secretarial help, and whose time and efforts are not restricted, such person will be deemed to be carrying on an unincorporated business even though, under the terms of his employment contract, he is considered an employee. If, however, this employee performs services in an office maintained entirely by his employer, and, if he is accountable to the employer both as to the method in which his affairs are carried on and the results obtained therefrom, it will ordinarily be held that he is not engaged in an unincorporated business.

An agent for a life insurance company, who maintains an office, is deemed to be engaged in an unincorporated business, despite the fact that he receives instructions from the insurance company as to his method of doing business. At least three cases on this point were decided by the courts in favor of the Tax Commission.

Recht et. al. v. *Graves,* 257 App. Div. 889, (1939).

Otis et. al. v. *Graves,* 259 App. Div. 957, (1940).

People ex. rel. Luther et. al. v. *State Tax Commission,* 291 N. Y. 691 (1943), affirming 265 App. Div. 976.

A trustee, receiver, assignee, or other legal representative of a defunct unincorporated business may either continue to operate such business or liquidate it. If conducted in the same manner as under the previous management, where stocks are replenished, etc., this would constitute the carrying on of a business. The fiduciary who liquidates such a defunct business would not be deemed to be carrying on an unincorporated business.

Allowance for Personal Services

In addition to the deductions previously cited, the law grants to proprietors or members of a partnership, carrying on an unincorporated business, a reasonable allowance for personal services actually rendered. The amount is to be determined by the Tax Commission, except that this allowance shall, in no event, exceed $5,000, for each individual or member of a partnership or 20% of the amount representing gross income, less the deductions provided for in Section 360, subdivision 1, of the Tax Law, whichever is the lesser, for each individual or member of a partnership. Note that interest, taxes,

depreciation, losses and bad debts are not included among these deductions.

Where all members of a partnership are not individuals, the allowance for personal services shall be confined only to those *individual members* of the partnership who are actively engaged in the business.

Ascertainment of Gains or Losses on Sales of Business Property Acquired Prior to January 1, 1935

The basic date applicable to the unincorporated business tax is January 1, 1935.

Consequently, in the sale or exchange of property (acquired prior to January 1, 1935), and connected with an unincorporated business, the basic date of January 1, 1935, would be a governing factor in arriving at the gain or loss realized therefrom.

The following rules will simplify the determination of gain or loss resulting from such sale or exchange:

1. Where both cost and January 1, 1935, values are less than the sales price, the basis for computing the profit shall be the *higher* of the two.

2. Where both the cost and the January 1, 1935, values are greater than the sales price, the basis for computing the loss shall be the *lower* of the two.

3. Where the selling price falls between the cost and the January 1, 1935, values, no gain or loss is realized.

Specific Exemption

Each unincorporated business is permitted a specific exemption of $5,000, provided such business has been in existence for an entire year. This $5,000 exemption shall be prorated where an unincorporated business has been functioning for less than one year. Thus, a business, using a short year of six months, would be allowed an exemption of $2,500. Only one such exemption shall be allowed, irrespective of the number of businesses conducted by an entrepreneur or partnership. The net income from all unincorporated businesses must be consolidated for purposes of reporting under this article.

Allocation of Net Income from Sources within and without New York State

An unincorporated business is subject to tax under this article on only that portion of the income attributable to New York State, provided that an office is maintained outside New York State. In the case of *Thompson* v. *Mealey**, decided by the Court of Appeals, in April, 1943, the petitioner was upheld in his contention that the maintenance of an office outside the state was not a prerequisite to qualifying for an apportionment under this article.

The Tax Commission, however, has not followed this rule, and is placing the burden on the taxpayer claiming an allocation to prove that he maintains an office outside the state.

If the records, maintained by the qualifying unincorporated business, clearly reflect the income earned within New York State, only that portion of the income is reportable.

If the books are not so kept, but the basis of allocation used by the taxpayer is accepted by the Tax Commission, only the income earned in New York State is subject to tax.

If, however, the method of bookkeeping does not reflect an apportionment of earnings within and without the state, the income earned in New York State is computed on the basis of a formula, as follows:

a) *Tangible Property Factor:* The percentage of the average value of the real and tangible personal property (connected with the unincorporated business) computed at the beginning and the end of the taxable year in New York State, divided by the total average value of all real and tangible personal property (connected with the unincorporated business).

* *Thompson* v. *Mealey,* 290 N. Y. 230 (1943), reversing 264 A. D. 437 (1942).

b) *Wages and Salaries Factor:* The percentage of the wages, salaries and other personal service compensation paid during the taxable year to employees in connection with the business carried on within New York State, divided by the total wages, salaries and other personal service compensation paid to all employees.

c) *Gross Sales Factor:* The percentages of the gross sales or charges for services consummated in New York State during the year, divided by the total gross sales or charges for services.

The three percentages thus obtained are averaged and the resulting percentage is to be used in arriving at the income subject to the unincorporated business tax.

Gains or losses from the sale of real property, or rentals received therefrom are excluded from this formula, and are wholly taxable if such property is located in New York State.

The Tax Commission unofficially permits a stock exchange firm, maintaining branches outside of New York State, to allocate 60% of its commission income to the office in which the orders originate. Thus, in a New York firm, in which a member partner owns a stock exchange seat and which partnership maintains a branch office in Hartford, the commissions earned on orders originating in Hartford and executed in New York are allocated 40% to New York and 60% to Hartford.

Requirements for Filing

Every unincorporated business having a gross income of more than $10,000, or a net income greater than the statutory exemption, is required to file a return. The return is due for calendar year taxpayers on April 15th; for fiscal year taxpayers, within the three and one-half months following the close of the fiscal year.

Payment of Tax

The tax is due in full upon the filing of the return. Extensions carry interest at 6% per annum.

Revision and Refunds

If a return has been filed, the Tax Commission may recompute and assess a tax at any time within three years from the date the return was due. Where a return has been filed, and the income understated by 25%, the Commission may recompute the tax within 5 years. If no return has been filed, the Tax Commission may compute the tax at any time. A taxpayer's application for refund must be made within two years from the filing of the return or, where no return was filed, one year from the date of the assessment or computation. Where a recomputation is made, the taxpayer may apply one year from the date of such recomputation.

Penalties

If a return is not filed, or the tax paid within sixty days after the due date, a penalty equal to 100% of the tax may be imposed (not less than $2.00), together with interest at the rate of 1% per month on the doubled tax.

If a return is filed and the tax is paid within sixty days after its due date, the penalties are 5% of the tax (but not less than $2.00) plus an additional 1% of the tax for each month or fraction thereof during which the tax remains unpaid.

A taxpayer who negligently understates the tax due, without intent to defraud, may be subject to a penalty of 5% of the deficiency, plus interest at the rate of 1% per month from the due date.

A wilful understatement of income, or the filing of a fraudulent return, by a taxpayer, may subject him to a penalty equal to 100% of the tax, plus interest at the rate of 1% per month on the doubled tax, from its original due date. In addition, the filing of a false and fraudulent return constitutes a misdemeanor; if convicted, the taxpayer may be fined $1,000, or imprisoned for the period of one year, or both, at the discretion of the court.

The criminal statute of limitations is two years from the date the return was filed.

* * *

Prior to 1938, proprietors, partnerships, or corporations, being members of another partnership, were obliged to include in their unincorporated business tax or franchise tax returns, their distributive shares of the net income from this partnership, which partnership previously had been taxed under this article. In the *Matter of Lowitz et al.,* v. *Graves,* 261 App. Div. 715; aff'd, no opinion, 287 N. Y., 613 (1941) the Commission was upheld on this point. The addition of Chapter 199 of the Laws of 1938 to Section 386D of the Tax Law eliminated such double taxation.

Codified Accounting in Czechoslovakia

By ARTHUR WEISSBARTH, C.P.A.

REVOLUTIONARY changes in the economic structure of post-war Czechoslovakia have produced an event which certainly makes news in the accounting profession. Legislation has recently been introduced making double-entry bookkeeping mandatory, with the exception of minor enterprises remaining in private hands. Simultaneously the attempt has been made to lay down in legal terms the basic requirements of sound accounting practice. The four pages of legislation(1) devoted to this task make interesting reading, indeed.

Codification of accounting became necessary in Czechoslovakia due to the transition from a system of competitive private enterprise to national or government ownership of nearly all important enterprises in the field of banking, insurance, mining, production of steel, chemicals, textiles, sugar, glass, porcelaine, chinaware, manufacture of shoes, and others. When, following this change, a two year plan, setting general production goals, was adopted it became obvious that uniform accounting principles, associative in character, had to be adopted in order to safeguard execution and control of the over-all economic plan. Future developments in Czechoslovakia, a highly industrialized country in the very heart of Europe, will be scrutinized by accountants, economists and political students everywhere. Success or failure of this experiment may have far-reaching repercussions.

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Obviously, the legislation enacted so far, represents but an outline or a basis for further official regulations the authority for the issuance of which has been vested in a newly created government agency. In the future this body will promulgate not only principles to be followed generally, but sample charts of accounts and complete accounting systems for each category of enterprises. It will set forth classes, names and functions of individual accounts and sub-accounts, the latter to be arranged according to the decimal system, so that like accounts and sub-accounts in various enterprises within the same group may be compared with ease. Simultaneously, statistical charts for these enterprises will be put on a uniform basis. To insure maximum utility, representatives of each trade in question will be invited to cooperate in the formulation.

Technically, the new legislation requires that the accounting system be such that assets and liabilities, and income and expenses be properly reflected, so that information necessary for further planning, imposition of taxes, control of management and individual departments may be secured in each enterprise. To this end, entries are required to be correct and sufficiently self-explanatory, and thus should permit of an easy audit. Chronological order combined with topical analysis in books of original entry and postings to a general ledger, at least once every month, are prescribed as the basis of entries in the accounting structure. Mixed accounts containing ele-

(1) Public Law (Czechoslovakia) #204, October 25, 1946; Regulation #205, November 5, 1946.

ments of assets and income must be avoided as well as setting off assets in one account against liabilities in another. Furthermore, provision has been made for maintaining control of subsidiary accounts, adoption of cost accounting with perpetual inventories, cost sheets, supporting records reflecting quantities only, or quantities and amounts. This change necessitated the repeal of a law enacted in 1863, which admitted as legal proof only bound books with numbered pages. Loose leaf machine and punch card systems thus have finally found official recognition after having been used extensively for years in government offices and private enterprises. However, loose leaf sheets must now be numbered consecutively, properly added and at the end of each accounting period must be assembled in permanent fashion, with the exception of records for receivables and payables. The latter must be ruled off and balances must be carried forward for further use. As an additional precaution, each individual loose leaf sheet must be numbered and the number recorded in a bound book. This rule applies to all accounts kept in this fashion. Destruction of entries or their alteration, creating doubt whether done originally or subsequently, is prohibited. Blank explanatory spaces and unused sheets in bound records must be ruled off.

Legislation concerning approval and entry of vouchers is provided for, as well as the time and method of their preservation.

It is obvious that particular attention has been devoted to defining the scope and method of preparation of financial statements. Taking physical inventory of assets and liabilities when closing the books has been made mandatory, as well as recording of asset values. The use of perpetual inventories is permitted, provided a physical count has been made within the last preceding four months. The same applies to other asset accounts in the event of actual count within the last half year. Inventories supporting statements have to be recorded in bound books or on loose leaf sheets, which subsequently must be assembled permanently. All financial statements required to be prepared at the end of each fiscal period must be drawn up in conformity with specimens to be issued by the above-mentioned agency, and they must be in agreement with the books. Statements, also, must be recorded within a limited period in permanent, bound records, and they must be signed by authorized officers, each of whom must indicate the date of his signing.

The above structure, undoubtedly, has certain features in common with accounting procedures established in this country by agencies of the government exercising control over public utilities. However, the presently existing Czechoslovak legislation in this field is probably but a beginning. Further and more detailed legislation may safely be expected for, thus far, nothing has been said concerning valuation of assets and inventories, depreciation and depletion, accruals and items to be deferred, etc.

Before concluding, it might be worthwhile mentioning that the profession of independent, officially licensed accountants has not existed in Czechoslovakia heretofore, despite the fact that this lack has been felt. Attempts to create a body of independent, licensed accounting experts came to naught in the middle thirties. Under the present status of things in Czechoslovakia, it is unlikely that any further steps toward official licensing of independent public accountants will be taken. Instead, for the time being, the direction seems to be toward the imposition of statutory penalties for improper bookkeeping and reporting under this new law.

A Note on Product Costs

By L. C. Andersen, C.P.A.

If a business is to have a sound sales program it is essential that the cost of each product which it manufactures be known. By "each product which it manufactures" is meant not only the product by its nature, but also the product by size of container in which it might be ultimately sold. It is quite conceivable that the cost of a product in a small container may be much greater per unit of that product than the cost per unit of the same product in a larger container.

With a knowledge of product costs, a Sales Department is in a position to know what products it is necessary to sell in order to achieve the greatest profit for the business. It may be that competitive conditions are such that a price cannot be obtained for certain products which will produce a satisfactory profit. In such a case, if the Sales Department is aware of this fact, it certainly should not place intensive sales effort behind this product. As a matter of fact, intensive effort is very often put behind a product on which an unsatisfactory profit is realized, simply because the Sales Department can, through that product, show nice volume increases.

Every business hopes to obtain a satisfactory profit, and if product cost data became generally available within an industry, that knowledge, of itself, would act to eliminate sales at prices which do not produce a satisfactory profit.

Apart from the use which the Sales Department can make of cost data, the men responsible for operation of the business can also use these product costs to determine which products they should manufacture based upon the ability to make a satisfactory profit on them and, from product costs, can determine the sources of income to the company.

Determination of product costs is not difficult, nor does it involve the use of an excessive amount of clerical help. One of the basic things needed for determination of product costs is factory records, that is, records showing the use of materials in the manufacture of various products. Without this, accurate product costs cannot be obtained.

Factory records, in addition to providing the basic data needed to determine product costs, also are a tool by means of which wasteful use of materials or theft of materials can be detected. As a matter of fact, efficient management should insist upon factory records being maintained whether or not these factory records are used as a basis for determining product costs. Without such records, wastage of materials and theft of materials might reach serious proportions without anyone knowing that such wastages or thefts were taking place.

As a public accountant who left public accounting to go into business, I have often felt that a Balance Sheet audit by a public accountant, while necessary in certain instances, does not give much of value to the operating executive in a business. The public accountant, if he interests himself in the costing field, can, in fact, make himself a business adviser to his clients and in that way win a place for himself in the minds of business executives that he does not now hold.

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Tax Accounting for Banks

By Max Rolnik, C.P.A.

The tax accounting problems of banks arise chiefly from the fact that the law and regulations grant them special allowances and privileges denied other taxpayers, and the fact that, due to the requirements of government bank examiners, the bookkeeping is ultra-conservative. As in the other papers in this series, the problems will be related to each important group of assets and liabilities. For example, under the heading of "Loans and Discounts" there will be taken up such topics as bad debts, and under the heading of "Securities" there will be covered such matters as losses on sales of bonds. The paper will be limited to federal income tax problems and, of necessity, will be far from exhaustive.

Loans and Discounts

At least until recently, the principal business of a bank was making loans to customers. The tax problems here involved relate, first, to the interest on the loans and, secondly, to the bad debts incurred and the recoveries thereon.

Interest and Discount:

The period in which interest and discount is earned depends primarily on the taxpayer's basis of accounting. The following rules have been established by decisions and rulings:[1]

On the cash basis, both interest and discount is earned when actually collected. This rule applies to obligations acquired on a loan to a borrower and those purchased from a third person. The fact that discount was deducted from the obligation when the loan was made, or when the obligation was purchased, does not represent a collection; the full tax basis of the obligation must be recovered before any discount is earned.

On the accrual basis, where the obligation was acquired on a loan to the borrower, or where a *non-interest* bearing obligation was purchased from a third person, both the interest and discount is earned as it accrues. However, where an interest-bearing obligation was acquired from a person other than the borrower, the interest is earned as it accrues but the discount is earned when it is collected, that is after the tax basis is first recovered.

Where an obligation is payable in installments, each installment is generally treated as if it were a separate obligation. This requires an apportionment of each payment on principal between the tax basis of the obligation and any discount on its acquisition.

The above rules apply to all forms of debt obligation—notes, mortgages, bonds, etc. — except the following: non-interest bearing obligations covered by section 42 (b), IRC, permitting cash-basis taxpayers to accrue the discount, and short-term government obligations covered by section 42 (c), IRC, requiring all taxpayers to treat the discount as earned when the obligation is collected, sold or otherwise disposed of.

Commission for granting or extend-

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(1) SM 3820, IV-2 CB 32, as modified by GCM 14839, XIV-1 CB 73; IT 2526 (IX-1, CB 123); *Shafpa Realty Corp.*, 8 BTA 283.

ing loans is to be reported, by a cash basis taxpayer, when collected; even if deducted from the amount of the loan when made, the commission is nevertheless to be taken up in income upon collection of the loan or its disposition. On the accrual basis, the commission is to be taken up in income when the loan is made.[2]

Banks and other creditors often receive partial payments on their loans and the problem arises as to how these are to be applied, that is, to principal or to interest. Where there is an agreement between lender and borrower as to the application of the payment, such agreement governs.[3] Where there is no agreement, the general rule is that the payment is to be applied against unpaid interest before it is applied against the principal of the debt.[4]

It should be observed that even on the accrual basis, interest is not to be taken up in income unless there is reasonable likelihood of collection.[5] Accordingly, where loans, bonds or other interest-bearing obligations are in default, or where the value of the collateral is less than the amount of the loan and there is a strong possibility that a loss will be incurred on the obligation, the creditor should stop accruing the interest.

Interest or other income is earned by a creditor on receipt from the debtor of collateral, voluntarily or on foreclosure. If the property so received has a value in excess of the tax basis of the obligation, the excess is income; and to the extent that it represents accrued interest previously unreported, it is to be taken up as interest. In this connection, attention is invited to the decision of the U. S. Supreme Court where a creditor bid in the collateral for the total of the unpaid principal of the debt plus accrued interest. The creditor was required to use the bid price, even though the bid price was higher than the fair market value of the collateral, and was held to have collected the accrued interest.[6] Although lower courts have since tried to distinguish similar cases before them, and have disregarded the bid price in favor of the market value of the collateral, nevertheless the Supreme Court decision should be a warning to taxpayers not to bid in collateral at more than the fair value.

Bad debts:

Bad debts are allowed as a deduction in the year that they become worthless and in no other. There is no requirement of determination of worthlessness by the taxpayer. Where a debt is wholly worthless, there is no necessity that the debt be charged off on the books. In the case of a partially bad debt, the Commissioner may allow the uncollectible portion if he is satisfied that the debt is recoverable in part, but the amount allowable by the Commissioner is limited to "an amount not in excess of the part charged off within the taxable year". The regulations permit a prior year's charge-off, should it not be allowed, to be included as part of the later year's charge-off.

A bank, like any other taxpayer, may use the reserve for bad debts method. In such a case, there is allowed as a deduction a reasonable addition to the reserve.[7]

Bonds are debts:

A taxpayer other than a bank ordinarily must treat the loss resulting from worthlessness of a bond as a loss from the sale or exchange of a capital asset. On the other hand, a bank is permitted

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[2] *Bonded Mortgage Co. of Baltimore* v. *Commissioner,* 70 F (2) 341; *Columbia State Savings Bank,* 31 BTA 685; *Vancoh Realty Co.,* 33 BTA 918 (NA); See also Note 1.

[3] *Huntington Redondo Co.,* 36 BTA 116 (A).

[4] *Plunkett,* 41 BTA 700, affd., 118 F (2) 644.

[5] *American Cigar Co.,* 21 BTA 464 (A); *American Central Utilities Co.,* 36 BTA 688(A); *Corn Exchange Bank* v. *U.S.,* 37 Fed. (2) 34.

[6] *Helvering* v. *Midland Mutual Life Insurance Co.,* 300 U. S. 216.

[7] Sec. 23 (k), IRC.

to treat the loss due to worthlessness of a bond as a bad debt, that is as an ordinary loss. The same rule applies also to "debentures, notes, or certificates or other evidences of indebtedness". However, all these securities must be "issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form."[8]

Charge-offs by order of bank examiners:

Banks have another privilege in that a conclusive presumption of worthlessness is given to debts charged off by order of government bank examiners.[9] The regulations provide that when a debt is charged off in whole or in part by specific order of supervisory Federal or State officers, such debt shall "be conclusively presumed" to have become worthless or worthless only in part if claimed as a deduction by the bank at the time of filing its return.

The bank need not claim the deduction in the year the charge-off is made by the order of the bank examiners. Instead, the bank may wait to claim the charge-off in a later year. For example, a bank charges off part or all of a debt by order of the bank examiners. It may claim the charge-off in its tax return and thereby accept the order of the examiner as a conclusive presumption of the worthlessness of the debt to the extent so charged-off. On the other hand, if the bank desires, it need not deduct the bad debt in the year it is charged off, but claim the deduction in a later year. It will be allowed the deduction provided, as is true of all taxpayers, it can show that the debt did in fact then become wholly worthless; or, if partially worthless, it can show that the debt did in fact become partially worthless in such year and was charged-off in that year in an amount equal to the deduction less the previously disallowed charge-offs of prior years.

The regulations make the charge-off by order of the bank examiners a conclusive presumption of worthlessness in the year of the charge-off only if the deduction is claimed by the bank in that year. There are still some unsettled points as to how far the regulations may provide for presumptions not in the law.[10]

Uncollectible deficiencies on sale of collateral:

While not specially applicable to banks, some comment is necessary regarding the problems involved when a creditor on foreclosure sale acquires mortgaged or pledged property. The regulations provide that the creditor may thereby have both (a) a bad debt and (b) a capital gain or loss. The varying effects of this rule can perhaps be explained by the following five examples:[11]

	(1)	(2)	(3)	(4)	(5)
(a) Bad debt:					
Indebtedness (tax basis to creditor)	$10	$10	$10	$10	$10
Purchase or bid price of property	10	10	5	5	5
Bad debt	—	—	$ 5	$ 5	$ 5
(b) Capital gain or loss:					
Obligation of debtor applied to bid price	$10	$10	$ 5	$ 5	$ 5
Fair market value of property	5	11	3	5	8
Capital gain or (L) loss	(L)$ 5	$ 1	(L)$ 2	—	$ 3

(8) Sec. 23 (k) and 117 (i), IRC.
(9) Sec. 29.23 (k) (1) (c), Reg. 111.
(10) *American National Bank of St. Paul,* T. C. Memo Op., Dec. 14, 1942; *Central National Bank of Richmond,* 1 T. C. 244.
(11) IT 3159, CB 1938-1, p. 188.

The regulations provide that the bid price shall be "presumed" to be equal to the fair value of the property in the absence of clear and convincing proof to the contrary.[12] Accordingly, if there is a bad debt based on the bid price of the property, there will ordinarily not be an accompanying capital loss or capital gain. In this connection, attention is again invited to the decision holding that where the creditor bids in property for the amount of the obligation plus accrued interest, he thereby collects the interest.[13]

Foreclosure does not by itself prove that there is a bad debt. The debtor is liable on the deficiency and it must be shown that there is no reasonable hope of recovery from him. If the deficiency is only partially collectible, the partial bad debt must, as in other cases of partial bad debts, be charged-off on the books.

If the foreclosure results in a third party's buying the property, the amount paid by him is applied to the claim of the creditor. If the unpaid balance is not collectible from the debtor, there is a bad debt to the creditor.

The above discussion was concerned with situations where the mortgaged or pledged property was sold by foreclosure either to the creditor or to a third person. There are situations where the debtor voluntarily transfers the property to the creditor in part or full settlement of the debt. In such cases, the transactions are treated exactly as if the debtor had paid the creditor cash equal to the value of the property so transferred. If there is an unpaid balance, which the debtor is unable to pay, there is a bad debt; if he is able to pay only part of the balance, there is a partial bad debt. Should the fair value of the property exceed the tax basis of the debt, the excess represents either interest or other ordinary gain.[14] Where the obligation is a bond, the transaction is a retirement of the bond. The subject of retirement of bonds will be discussed below.

Whether the collateral was acquired by the creditor by foreclosure or by voluntary transfer, the fair value of the property at time of acquisition is considered the tax basis for future gain or loss or for depreciation.[15]

Recoveries:

Bad debts or other deductions of one year recovered in a subsequent year ordinarily result in income in such subsequent year. The one exception to this is where the deduction was of no income-tax benefit.[16] While the law includes in the non-taxable recoveries only "bad debts, prior taxes and delinquency amounts", the decisions and the regulations go beyond this limited group of deductions. The only deductions to which the non-taxable recovery rule does not apply are depreciation, war amortization, depletion and amortization of bond premiums. The Board of Tax Appeals has held that where a creditor acquires property as a result of foreclosure and incurs a bad debt, which is of no tax benefit, the basis of the property for future gain or loss is, nevertheless, the fair market value at the time so acquired. Accordingly, when he subsequently sells the property, any gain may not be treated as a non-taxable recovery.[17] The regulations provide for the manner in which the recoveries are to be applied to prior charge-offs in order to determine the extent to which the deductions were of no tax benefit.

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(12) Sec. 29.23 (k) (3), Reg. 111.

(13) See Note 6.

(14) *Commissioner* v. *National Bank of Commerce of San Antonio,* 112 Fed. (2) 946; *Elverson Corp.* v. *Helvering,* 122 Fed. (2) 295; *Manhattan Mutual Life Insurance Co.,* 37 BTA 1041 (A).

(15) *First National Bank of Philipsburg,* 43 BTA 456.

(16) Sec. 22 (b) (12), IRC.

(17) See Note 15.

The Bureau of Internal Revenue has ruled that where a bank follows the practice of offering for sale loans evidenced by notes which, by reason of the financial condition of the borrower, become of doubtful value, the gains or losses on the sale are ordinary gains or losses and not capital gains or losses.[17a]

Securities

Securities, particularly U. S. Government obligations, are an important source of income to banks. The tax problems relate chiefly to the treatment of interest and dividends on the securities, the treatment of gain or loss on sale, retirement or worthlessness, and the amortization of bond premiums.

Interest and dividends:

The interest on all obligations of States and their political subdivisions is entirely exempt from income tax. In the case of obligations of the United States, the interest on some of the obligations is entirely exempt, on other obligations exempt only from the normal tax, and on still other obligations fully taxable.

Dividends received on stock of Federal reserve banks, Federal land banks and National farm-loan associations issued before March 28, 1942, are entirely exempt.

The rules as to when interest is earned were given above and need not be repeated. These rules apply not only to loans and discounts but to mortgages, bonds and other obligations. There is one additional rule which should be discussed at this point because it applies chiefly to bonds. The cost of a bond purchased at a price *plus* accrued interest is made up of two parts, the cost of the principal of the bond and the cost of the accrued interest. Consequently, interest collected thereafter should be applied against the accrued interest and only the excess be treated as income. Where a defaulted bond is purchased "flat", the cost is, however, not divided between the cost of the principal of the bond and the cost of the accrued interest. Accordingly, the accrued interest collected is applied against the full cost and, only after the cost is recovered, is the excess treated as income. Of course, the collection of any interest that accrues after the purchase date must be treated as interest income.[18]

Net loss on sale of bonds:

Except in the case of a bond dealer, bonds are capital assets and any gain or loss on sale, exchange, or retirement is a capital gain or loss. However, special provision in the law makes an exception in the case of banks. When a bank has a net loss on sale, exchange or retirement of bonds (that is, an excess of losses over gains), the net loss is considered an ordinary loss. As in the case of worthless bond, which a bank may treat as a bad debt, this net loss privilege applies not only to bonds but to "debentures, notes, or certificates, or other evidence of indebtedness." All the securities must be "issued by a corporation (including one issued by a government or political subdivision thereof) with interest coupons or in registered form."[19]

The privilege does not apply to the sale of ordinary mortgages or to the sale of corporate stock, and consequently gains and losses on the sale of such items must be included with other capital gains and losses.[19a]

The charge-off by a bank of corporation stock by order of Federal or State authorities is considered prima facie evidence of worthlessness, provided the order was based on complete worthlessness. A charge-off where there was no reasonable attempt to determine worthlessness, for example, based on market fluctuation, is not deductible.[20]

(17a) IT 3648, CB 1944, p. 268. Compare *Kanawha Valley Bank,* 4 TC 252.
(18) *Erskine Hewitt,* 30 BTA 962 (A).
(19) Sec. 117 (i), IRC.
(19a) See note 17a.
(20) Sec. 29.23 (e) (4), Reg. 111.

Banks, as part of their business, often deal in securities, that is, buy them for sale to customers. In such event, the securities are stock-in-trade, not capital assets.[21] The following results follow: The gain or loss on their sale are ordinary gain or loss. The premium paid on their purchase is not amortized. The securities may be inventoried at cost, cost or market, whichever is lower, or at market. Buying commissions are added to the cost but selling commissions are deductible as an ordinary expense.

If a bank holds certain securities as a dealer and other securities as a trader or investor, the dealer securities should be ear-marked and the transactions in them should be clearly recorded as dealer transactions so that there will be no question of the separation of the two types of businesses. The Bureau of Internal Revenue has ruled that securities of a type ordinarily sold to a dealer's customers may not be treated as capital assets.[21a] The validity of this ruling is questionable.

Securities acquired by a bank as a result of foreclosure are not to be treated as property held for sale to customers. Gain or loss on sale thereof is to be treated as a capital gain or loss.[22] Of course, if the securities are bonds, the rule that a net loss on sale of bonds is an ordinary deduction will apply.

Amortization of bond premium:

The requirements as to amortization of bond premiums are the same for banks as for other corporations. All corporations must amortize the premium on bonds which are entirely or partially exempt, and they have the option of amortizing the premium on fully taxable bonds. The amortization of bonds, the interest on which is subject to surtax only, is allowable as a deduction only in computing surtax net income. No deduction from net income is allowed for amortization of bond premium on wholly exempt bonds, such as State or municipal bonds, but the tax basis must nevertheless be reduced because of the amortization.[23]

The only special tax accounting problem of banks involved in the case of bond amortization is due to the fact that they often write off the amortization at a faster rate or by some other method than is provided for in the regulations. They must therefore take particular care to account for the differences in the amortization deduction and the effect on the tax basis.

Bank Premises and Other Real Estate

Banks are generally very conservative in accounting for their bank premises, and write down the cost very drastically. An even more conservative policy is adopted with respect to fixtures and equipment, which are often charged to expense when acquired. For income tax purposes, capital expenditures are not deductible, even if the charge-off is by order of bank examiners.[24] Depreciation should be claimed on depreciable property, including that charged off, on the basis of the useful life of the property.

Aside from the accounting feature, the principal point in regard to bank premises and other real estate is the relief granted by the law with respect to the sales of property, used in trade or business of the taxpayer, of a character which is subject to the allowance for depreciation, or of real property used in trade or business of the taxpayer. A net gain on the sale of such assets held for more than six months

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(21) *Harriman Natl. Bank* v. *Commissioner,* 43 Fed. (2) 950; *Denman* v. *Squire,* 111 Fed. (2) 921; IT 2564, X-1 CB 106; Mim. 3990, XII-1 CB 97.

(21a) IT 3828 (1946-25-12453) Compare section 29.22(c)-5, Reg. 111, and *Harriman National Bank* v. *Commissioner,* 43 F (2) 950.

(22) *Kanawha Valley Bank,* 4 TC 252.

(23) Sec. 23, 125, and 113 (b) (1) (H), IRC.

(24) IT 2985, CB XV-1, p. 119.

is a long-term capital gain.[25] There is no question involved as to whether the assets are used in trade or business if the assets are bank premises or bank fixtures or office equipment. A question arises, however, with respect to real estate which a bank acquires as a result of foreclosure of collateral and which it is required by law to dispose of within a reasonable time. Are such assets held in the trade or business of the bank? One decision of the Tax Court has held that where a bank acquired by foreclosure collateral made up of corporate stock and undeveloped land, which it later sold, the loss on the sale was a capital loss since the assets were not held for sale to customers.[22] That case involved, however, taxable years prior to those covered by section 117 of the present law. More recently it has been held that, where real property is income-producing, it is to be treated as being held in trade or business.[25a] Under the present law, therefore, a loss on the sale is an ordinary loss, while if the property were held for more than six months, the gain would be a capital gain.

As explained above, property acquired by foreclosure or by voluntary transfer has a tax basis for depreciation, or for computation of gain or loss on sale, equal to the fair market value of the property at the time acquired. In the case of depreciable property this basis must, of course, be reduced by subsequent depreciation.

Accrued Expenses

A taxpayer on the cash basis is not allowed any deduction for expenses, interest, taxes, etc. unless they have been paid during the taxable year. An accrual basis taxpayer must accrue expenses, interest, taxes, etc. However, a taxpayer may not accrue an item for which he denies liability.

In one case the interest deduction was not allowed to a cash basis taxpayer, even though the amount of interest was computed at the close of the taxable year, because it was not available to the depositors until the beginning of the next year.[26]

Reserves

Banks, like other conservative taxpayers, set up reserves for shrinkage in value of investments, for losses and for other contingencies. Additions made to such reserves are not deductible.

Additions to reserves are often made by crediting profits or other income direct to the reserves. These credits, to the extent that they represent taxable income should, of course, be included in the tax returns. Likewise, the charges made direct to the reserves, for allowable losses or other deductions, should be deducted in the returns. A distinction should be made between a non-deductible reserve and an accrued liability for expenses, taxes, etc. The depositors' guaranty fund required to be set apart by State authorities and which may be withdrawn by these authorities, with no portion returnable to the bank, is a deductible expense.[27]

Surplus and Undivided Profits

The surplus and undivided profits accounts of banks often contain debits and credits representing income and deductions which should be included in the income tax returns, for example, expenses, profits and losses.

National and state banks and trust companies and certain other banking and insurance companies are allowed, as a deduction, dividends paid on their preferred stock owned by the United States or certain instrumentalities thereof.[28] Such dividends do not include distributions in liquidation. This allowance applies chiefly to stock of a bank held by the Reconstruction

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(25) Sec. 117 (j), IRC.
(25a) *Fackler* v. *Commissioner,* 133 F (2) 509; *Leland Hazard,* 7TC No. 44(A).
(26) *First National Bank of Braddock,* 38 BTA 1244 (A).
(27) Sec. 29.23 (a)-12, Reg. 111.
(28) Sec. 23 (r), and 121, IRC.

Finance Corporation. The dividends on the preferred stock of the bank so held are treated the same as interest paid on a loan. Taxes paid by a bank or other corporation, assessed against stockholders on account of their ownership of shares, may be deducted by the bank or other corporation if there is no provision for reimbursement by the stockholders.[29]

Preparation of Returns

In analyzing the transactions of a bank for the purpose of preparing the tax returns, two general rules should be observed. In the first place, items subject to special treatment should be carefully noted: Interest on State and municipal obligations, and dividends on stock of Federal reserve banks, Federal land banks and National farm-loan associations issued before March 28, 1942, are exempt from tax. Losses from worthless bonds should be claimed as bad debts. A net loss on the sale of bonds is an ordinary deduction, not a capital loss.

In the second place, it is highly desirable to maintain memorandum records of write-downs of loans, securities, real estate, fixtures and other assets, where the write-downs were not allowed as deductions, and to check these records every time a return is prepared so that bad debts, depreciation, losses, or other deductions, may be claimed with respect to these write-downs.

(29) Sec. 33 (d), IRC.

Economics of Accounting

By Lewis Gluick, C.P.A.

The title of this article was the title of a book, published in 1929 by The Ronald Press Company. The author was Canning, a Professor at Stanford University. To our great distress, we find the book is now out of print. A search of many second-hand stores in Long Beach and Los Angeles did not uncover a copy. That is not surprising. A book as good as that stays sold.

We hear that the author is retired. It is a pity that no colleague has seen fit to revise the book and bring it up-to-date. Economics is a subject with which every C.P.A. should be thoroughly conversant. (See the Journal of Accountancy, February, 1947, page 100). Some states include an examination in Economics as part of the tests for a certificate. New York, requiring a college course which includes Economics, accomplishes the same purpose.

The first (Saliers) edition of The Accountants' Handbook included a section on Economics, by Irving Fisher. A bigger mystery than Simon and Schuster or Ellery Queen ever published is why the Paton editions dropped it. Irving Fisher, originally a mathematician only, introduced elementary students to the balance sheet early in his courses. Many universities, not blessed with a College of Commerce, put their courses in Accountancy under the Economics Department.

Recently we have resumed our pursuit of Economics by studying a 731 page book by John Ise, Professor at the University of Kansas. We regard it as unfortunate that Harper and Bros. have placed such copyright restrictions on it that we cannot quote at length. Ise's treatment of his subject definitely and permanently buries an old definition of Economics as "the dismal science". However, there is nothing but the possession of five dollars and the willingness to spend it, to prevent any of you from enjoying it in full.

Lewis Gluick has been a member of our Society since 1924. He is now engaged in practice in Long Beach, California. He is best known as the Shoptalker, under which name he has been writing since 1928.

The old accepted definition of Economics was "the science of wealth". Whereupon, of course, the economist has to define "wealth". But no matter how the successors of Adam Smith split hairs, wealth is what the accountant is dealing with in all his work. If he is not thoroughly familiar with Economics, not only he, but his clients will suffer. A few cases in point.

Almost anyone, granted elemental literacy, can, with a little practice, prepare Social Security Tax returns. *Why* are they being prepared? Why was the law enacted? A study of Economics provides the answer. What good to the bookkeeper or payroll clerk is the answer even if she has it? In dollars and cents on her own paycheck, very little.

Let us, however, re-tell an old story of three masons who were hacking away at rough ashlars. To the inquiring philosopher who asked what they were doing, one replied, "I'm cutting stone". The second said, "I'm fitting this stone to the builder's use". The third answered, "I am helping to build a temple".

The clerk who knows why she is figuring payroll taxes takes an interest in her work that normally leads to increased precision and marks her for advancement. The auditor who sits down with his client to discuss the tax burden will command greater respect (and even a greater fee) if he can give reasons.

Let us consider the matter of land. As pointed out in our article in the September, 1946, issue, it is the basis of everything. Over a century ago, an economist named Ricardo announced the principal of marginal utility. He applied it only to land. But just as *pi* pervades mathematical formulae which have nothing to do with circles, marginal utility and the law of diminishing returns pervade all business. Is your client contemplating expansion? Or has he, without consulting you (as usual) expanded and now demands that you tell him where the profits are? A budget in the first instance, or a statement of application of funds in the second may suffice; but a knowledge of Economics will improve them.

Do you have a good idea of Jevon's "sunspot theory"? Whether you agree or not, you should know what it is. Are you well-grounded in Henry George's theory of land? Can you discuss Communism and other isms affecting free-enterprise beyond the subjective scope of your own practice?

If you can answer these and similar questions affirmatively, congratulations! If not get acquainted with modern Economics.

A sign in a drug store window reading "Why worry about your income taxes when our expert tax accountants can save you time and money," has been staring me in the face for several weeks. If I can read between the lines, this is the real message of the sign:

The Ides of March

Easy, brother, do not worry
Here we fix you in a hurry:
We sell pills, and salts, and tonics,
Chow Mein and works of onyx.
Headaches, rashes, ails of mortals
Disappear within our portals.
Even pesky income tax
Finds relief in tried Ex-Lax!

But to be yet more specific
We propose things terrific
Income problems and expense
May be solved by common sense,
But net operating loss
Often merits all the fuss.

Excess profits indigestion
Is no more a weighty question;
Cap'tal losses and other ills
Really call for special pills,
And C-C powder kills the pains
Sometimes found among your gains.

Why, then, seek a C.P.A.
Doing taxes the expert way?
Come to us; we'll do your work.
Just consult our soda jerk!

A. S. Orlans, C.P.A.

New York State Tax Clinic

Conducted by Benjamin Harrow, C.P.A.

"Doing Business"

If a foreign corporation wishes to exercise its corporate franchise or do business in this state, it must qualify by obtaining a certificate of authority from the Secretary of State (Sec. 210). It must also pay a license fee measured by its issued capital stock employed in New York (sec. 181). This is determined by measuring gross assets employed in New York, excluding however obligations of the United States and cash, in relation to total gross assets exclusive of cash and United States obligations. If a foreign corporation fails to qualify to do business it is prohibited from bringing suit in a state court on a "contract entered into within the state while doing business therein".

Statutory Provisions with Respect To Doing Business

Article 9A is concerned primarily with the question of whether a foreign corporation is doing business so as to be subject to the franchise tax. New York has no authority to tax interstate activities. Its jurisdiction is recognized when the activities may be said to be intrastate. Article 209.3 provides that "the holding of real property in this state shall be deemed to be doing business in this state * * *". Other than this provision there is nothing that defines positively what constitutes doing business.

The same section of the law enumerates certain specific acts that do not constitute doing business in this state. These are:

1. The maintenance of cash balances with banks or trust companies in this state.
2. The ownership of shares of stock or securities kept in this state if kept in a safe deposit box, safe, vault or other receptacle rented for the purpose, or if pledged as collateral security or if deposited with one or more banks or trust companies, or brokers who are members of a recognized security exchange, in safekeeping or custody accounts.
3. The taking of any action by any such bank or trust company, or broker, which is incidental to the rendering of safekeeping or custodian service to such corporation.
4. Any combination of the foregoing activities.

Prior to March 31, 1944, when new article 9A became effective, this section also provided that having office furniture and fixtures in this state would not be deemed to be doing business for franchise tax purposes. The deletion of this provision in new article 9A is undoubtedly significant.

Court Decisions on Doing Business

A foreign corporation may maintain an office in New York for the solicitation of orders without thereby subjecting itself to the franchise tax. That is not considered as doing intrastate business for franchise tax purposes. It would be, however, if the orders are accepted in New York.

A foreign parent company owning all the stock of a subsidiary company would not by reason of that fact alone be doing business in New York merely because the subsidiary was engaged in activities in New York.

The real problem that bothers the State Tax Commission and the corporation arises when the affairs of both companies are controlled by the same officers and the parent company has only a statutory office outside New York. New Article 9A was designed to ease the tax burden on such parent companies. It virtually invited such corporations to come into New York and openly qualify to do business in the State. Under the present law such corporations would be exempt from tax on subsidiary income, but it would pay a tax on its subsidiary capital of only one-half a mill on the first $50,000,000 of capital.

Unincorporated Business Tax—Exemptions

Prior to 1935 the unincorporated business seemed to enjoy a tax advantage over a business employing the corporate form, in that the latter was subject to a so-called special franchise tax but determined on the basis of its net income while the former was not subject to any comparable tax. This tax was an attempt to place the unincorporated business and the corporate business on a parity. It was the first tax of its kind in the United States. A partnership not otherwise taxed on its income is taxable under this tax as a business entity.

The law specifically exempts the practice of law, medicine, dentistry, and architecture from the tax because these professions may not be conducted under a corporate structure. But the exemption covers any other profession "in which more than eighty per cent of the gross income is derived from the personal services actually rendered by the individual or members of the partnership * * * and in which capital is not a material income producing factor". Accounting has been recognized as such a profession. So has teaching, but if a group of teachers run a private school as a business, such business would be subject to the unincorporated business tax even though the official ruling would seem to entitle the teacher to consider himself as coming within the exemption. The Commission probably feels that private schools may incorporate if they wish, in which event they would be subject to the franchise tax. Furthermore if the rule were relaxed too many teachers of all shades would be brought into the exempt class. In an actual case before the Commission the conferee pointed to the thousands of dancing teachers who conduct classes and who sought such exemption. The Commission distinguishes between vocations and professions entitled to the exemption.

A number of cases have come before the Courts on this issue. A Custom House broker was held not to be practicing a profession in the sense in which the term is used in the law. Nor an insurance broker nor a so-called industrial engineer, nor a self-styled food engineer nor a marketing consultant, nor even an investment consultant.

But an industrial designer was held by the courts to be an exempt "learned" profession, and it was probably on the basis of this case that the commission in a recent case finally agreed that a scenic designer should enjoy an exempt status.

Probably on the basis of the court's decision in the marketing and investment consultant cases, the Commission is presently attempting to tax a consulting economist under this law. To this editor it would seem that a consulting economist is in a learned profession requiring training, knowledge, and experience in a scientific or learned field, and that since in his practise capital is not a material income producing factor, he should enjoy the exemption from the unincorporated business tax.

Nonresidents

About a year ago the Treasury Department started a drive to collect taxes from so-called nonresidents who were in the United States "making money", particularly in the stock market, without being subject to tax on such profits because of the favorable provisions in the law exempting such profits. The usual line of attack was to hold that the nonresident was a resident for tax purposes particularly if he was continuously in this country for at least a year. The nonresident's troubles with the taxing authorities did not end there, for the State Tax Commission followed on his trail making its demands.

Article 501 of the Regulations defines a resident of New York as one who even though domiciled outside the State of New York, maintains a permanent place of abode within the State and spends in the aggregate more than seven months of the taxable year within the State. This definition was declared

to be constitutional in the *Ryan* case, 262 N.Y. 1.

Our nonresident who came to the United States at the outbreak of the war and has resided here for a number of years will find that he seems to fit neatly into the classification of resident and that he is therefore taxable on his income from all sources. He will resist this classification of resident on the basis of Article 503 of the Regulations which defines permanent place of abode. "On the other hand, a person who comes into the state to accomplish a particular object, intending to remain only for that temporary period, who establishes a home and spends more than seven months of the taxable year within the state, is not to be considered as maintaining a permanent abode within the state unless there is evidence to show an intent to make the home so established a permanent one."

Take a typical case. A nonresident operator of ships comes to New York early in 1940 intending to stay for a temporary period. He is unable to leave because of the war and remains in New York until 1946. While here he trades in the stock market and perhaps buys and sells some ships and even operates a few through the Maritime Commission. A number of questions suggest themselves. Is he a resident of New York: If not, is he doing any taxable business in New York? The editor invites discussion from the membership on these questions.

SOME DIFFERENCES BETWEEN THE NEW YORK AND FEDERAL INCOME TAX LAWS

Capital Gains and Losses

Under the New York law capital gains and losses are separately computed and separately taxed, the applicable rates being one-half the rates on ordinary net income. Capital losses are deductible only from capital gains. There is no classification as between long term and short term transactions. A net capital loss may be carried over for the next succeeding five years and deducted from net capital gains for those years until absorbed. No portion of a net capital loss is deductible from ordinary net income. Expenditures incurred in connection with the sale of capital assets are classified as capital deductions and are deductible only in computing net capital gain or net capital loss. The regulations (Article 485-b) say that capital deductions include broker's commissions, stock transfer taxes, legal expenses incurred to complete the sale, and other similar expenditures.

Requirement for Filing Returns and Exemptions

A return is required of every single individual having a net income and net capital gain of $1,000 or more. This requirement applies also to a married person not living with husband or wife.

In the case of a husband and wife living together a return is required if the aggregate net income and net capital gain is $2,500, or more. A joint return or two separate returns may be filed.

If a single individual has a gross income and capital gain of $5,000, or if husband and wife have an aggregate gross income and capital gain of $5,000, a return must be filed, regardless of the net income.

The personal exemption of a single individual is $1,000. The personal exemption for husband and wife is $2,500 and this may be divided between them, if separate returns are filed, in any way they choose. If the status changes during the year the exemption is prorated.

Estates and trusts receive a personal exemption of $1,000.

The credit for a dependent is $400 and it should be noted that the meaning of dependent is quite different from the Federal concept. A dependent must be under eighteen or, if over eighteen, incapable of self-support because mentally or physically defective. The legislature in 1943 added a provision to the section on the dependency credit (sec. 362 (2))

permitting a credit of $400 to a dependent over 18 if he is in full time attendance at an approved school or college. The New York law still retains the status of head of a family, who is likewise entitled to a personal exemption of $2,500. It should be noted that to the extent that the personal exemption exceeds net income, it may be taken as a credit against net capial gain.

Compensation Covering Services Rendered over a Period of 36 Months

New York State does not provide for any special treatment of such compensation as the federal does. (I.R.C. Sec. 107.)

Interest on Government Obligations

New York exempts interest on federal obligation and on obligations of the State of New York and its political subdivisions. It likewise exempts interest on bonds of the New York Savings and Loan Bank and limited dividends of Housing Companies organized under the State Housing Law. It should be noted that interest on obligations of states other than New York are taxable, although such interest is exempt from federal tax. Section 359 (2)(f) also contains a provision added by the legislature in 1941 that interest accrued on a debt secured by a lien of real property which is paid solely by means of being applied or credited in satisfaction of a bid by the creditor at a sale held for the enforcement of such lien is excluded from gross income.

Interest on Tax Free Covenant Bonds

New York does not allow a tax paid at source as a credit such as the federal law permits on bonds issued before January 1, 1934. In fact there is a provision in the law (Sec. 385) that "it shall be unlawful for any person to agree or contract directly or indirectly to pay * * * any tax payable under the provisions of this article."

Stock Dividends

Stock dividends are not subject to tax under New York law (sec. 350(8)). The regulations define stock dividends as meaning new stock issued for surplus or profits capitalized to shareholders in proportion to their previous holdings. The treatment of stock dividends is broader and more liberal than under the federal law. However in a lengthy ruling of the Tax Commission issued in 1924, it held that treasury stock distributed as a dividend was taxable. This ruling goes into a lengthy analysis of the Eisner vs. Macomber decision and distinguishes the distribution there exempted from a distribution of treasury stock.

Deduction for Interest

Generally all interest paid or accrued on indebtedness is deductible. The regulations except interest paid in connection with the ownership of real or personal property current income from which is excluded from gross income. The New York law does not exclude interest incurred to purchase a single premium life insurance or endowment policy.

Deduction for Taxes

The New York law allows no deduction for federal income, estate or gift taxes. Nor does it allow a deduction for State income taxes as the federal law does. Stock transfer taxes are deductible only in computing capital gain or capital loss. Federal excise taxes are still deductible, although these are no longer deductible under the federal income tax law unless they qualify as a business expense.

Deduction for Losses

So-called family losses sustained in transactions between members of a family, partners, individual and controlled corporation, grantors, fiduciaries and beneficiaries of trusts are allowed, although disallowed under federal law.

A loss on worthless stocks is deducti-

ble as a capital loss the same as under the federal law.

The New York law has no special provision with respect to so-called wash sales, so that such losses are deductible.

The New York law makes no provision for a net operating loss deduction, something that should be in the law.

Miscellaneous Deductions

There is nothing in the state law comparable to the standard deduction under the federal law. Like the federal law the state permits a deduction for medical expenses and for alimony payments. In the case of alimony payments the deduction is allowed to resident husbands and in the case of nonresident husbands there is a limitation based upon the payments includible in the gross income of the wife. The New York law allows a deduction for life insurance premiums in an amount not exceeding $150.

Basis for Determining Gain or Loss

In the case of property acquired prior to January 1, 1919, cost or market value on January 1, 1919, whichever is higher is the basis for gain, and cost or market value on January 1, 1919 whichever is lower is the basis for loss.

In the case of property acquired by gift prior to December 31, 1927, the basis for gain or loss is the market value when acquired. If the property was acquired by gift after December 31, 1927, the basis for gain is the donor's basis and for loss is the donor's basis or market value at time of gift whichever is lower.

Involuntary Conversions

No gain or loss is recognized under State law, whereas the loss is recognized under the federal rule.

Subsidiary Income— Incongruous Situation

Benjamin Grund calls our attention to what he calls "a seemingly incongruous situation that develops whenever a subsidiary corporation pays interest on indebtedness to its parent company and both corporations file separate franchise tax returns under Article 9A of the Tax Law". In such a case the parent corporation is required to include in its income the interest from the subsidiary corporation to the extent that it is claimed by the latter as a deduction in computing its net income subject to franchise tax. It should be noted that the subsidiary is limited in the amount it may deduct to $1,000. Mr. Grund suggests that the subsidiary should waive is deduction of $1,000. In that event, the parent would not be required to include in its income subject to franchise tax, the interest received from the subsidiary. Form 3 C.T. does not expressly call attention to this situation and Ben Grund thinks that this alternative method of reporting interest should either be made mandatory or should be clearly set forth on form 3 C.T. Otherwise, there is a duplication of tax.

NOTES ON BILLS THAT HAVE BEEN INTRODUCED IN THE LEGISLATURE NOW IN SESSION

What Is a Real Estate Corporation

Section 182-(1) permits a real estate corporation to retain its classification as such, if not more than 10% of its average gross assets consisted of stocks, bonds or other securities. Assembly Bill No. 888 would add to this provision loans to wholly owned subsidiaries taxable as real estate corporations.

The present law permits a real estate corporation to invest in United States securities in any amount without losing its classification. Originally this provision (Sec. 190) was effective until the first taxable year after the termination of the war. Assembly bill No. 881 provides that the classification shall not be affected if such securities were purchased after January 1, 1941, and were owned on December 31, 1946.

Additional Tax on Dividends

A real estate corporation pays an

additional tax of 2% on dividends paid during the year. As the law stands now (Sec. 182 (1)) interest paid on debenture bonds or certificates of indebtedness or certificates of beneficial interest or promissory notes or other indebtedness to stockholders is treated and taxed as dividends if the proceeds of the indebtedness were used to acquire assets. Assembly bill N. 888 would modify this provision somewhat. First it proposes to tax only 90% of the interest. Second it includes interest on indebtedness to members of the immediate family of any stockholder owning in the aggregate in excess of 5% of the issued capital stock of the corporation. Third such interest up to an amount not exceeding $1,000 would not be taxed in any event.

Upon a change of classification from a real estate corporation, the real estate corporation becomes liable to the additional dividend tax on its surplus. The same bill would exclude from this taxable surplus any surplus existing at the time of a change of classification from one taxable under Article 9A to that of a real estate corporation.

Entire Net Income under Article 9A

Sec. 208 (9)-5 limits generally the deduction of 90% of interest on indebtedness to any stockholder or members of his immediate family owning in excess of 5% of the issued capital stock of the corporation.

Assembly bill No. 889 enlarges the meaning of stockholder to include subsidiaries of a corporate stockholder. This apparently is a department measure to prevent the avoidance of the provisions of paragraph 5, where a taxpayer corporation pays interest to a subsidiary of a corporate stockholder and technically would be permitted a full deduction for the interest paid.

Deduction for Franchise Tax

In a previous column we pointed out some inequities resulting from the provision in Sec. 208(a) (b) which allows a deduction for the franchise tax based upon the period immediately preceding the period covered by the report. Assembly bill No. 889 attempts to correct one of these inequities. It provides that in the last report of a taxpayer corporation the tax based on the period covered by such last report shall also be allowed as a deduction. In effect a corporation on a final return is permitted a deduction for two franchise tax years.

Salary Elimination Basis for Computation of Tax

One method for determining the tax is to add to entire net income compensation paid to officers and stockholders owning more than 5% of its issued stock, then deducting $5,000 and applying the tax rate to 30% of the resulting balance. Assembly Bill No. 889 would amend this basis by increasing the specific exemption of $5,000 to $15,000.

OFFICIAL DECISIONS *and* RELEASES

AMERICAN INSTITUTE OF ACCOUNTANTS

13 East 41st Street, New York 17, N. Y.

STATE SOCIETY SERVICE DEPARTMENT

Opinions of the Ethics Committees of the American Bar Association and the American Institute of Accountants

January 20, 1947.

At a meeting of the National Conference of Lawyers and Certified Public Accountants held in Cincinnati, Ohio, December 15, 1945, it was agreed to submit questions concerning the practice of accounting and law to the committees on ethics of both the American Institute of Accountants and the American Bar Association. For your information, we enclose herewith copies of these questions, together with the opinions of both committees.

These opinions will be published simultaneously in the February issue of The Journal of Accountancy and the Bar Journal, but it is felt that state societies and chapters will find them of value prior to that time.

/s/ A. H. Robertson,
Director.

May 8, 1946.

To the National Conference of Lawyers and Certified Public Accountants

Gentlemen:

The Committee on Professional Ethics of the American Institute of Accountants has considered the following questions submitted to it under date of March 4, 1946, by the National Conference of Lawyers and Certified Public Accountants:

"A. Is it ethical and proper accounting practice for a firm of accountants to employ a lawyer on a salaried or other compensatory basis, and permit the lawyer to practice law for the clients of the accounting firm? Does it makes any difference if the services of the lawyer are billed to the client separately, and the accounting firm participates in no way in the compensation received for the legal services? Does it make any ethical difference if, by leave of absence or other temporary arrangement, the accounting firm considers that the lawyer renders the services on his own time, and the lawyer bills the client independently?"

"B. Is it ethical and proper accounting practice for a certified public accountant to be employed by a law firm, and to prepare and certify financial statements under his own name as a C.P.A., for the clients of the law firm? Does it make any ethical difference if the said services of the accountant are billed to the client separately, and the law firm participates in no way in the compensation received for the said accounting services? Does it make any ethical difference if, by leave of absence or other temporary arrangement, the accountant considers he is rendering said services on his own time, and the accountant bills the client independently?"

"C. Is it ethical and proper accounting practice for a certified public accountant, who is also licensed to practice law, to practice law for his clients? Assuming that it is proper for him to practice law, may he go into partnership with a lawyer and continue to prepare and certify financial statements under his own name as a certified public accountant for the clients of the firm, or may he go into partnership with a certified public accountant and continue to practice law for the clients of the firm? Does it make any difference if by billing separately or maintaining separate offices, or any other method, he considers that the partnership has no interest in the work he does, which is denied for the partnership to do?"

1. The Committee on Professional Ethics of the American Institute of Accountants believes that the primary justification for rules of professional conduct or codes of ethics is to safeguard the public interest; that is, to induce on the part of members of the professional group a mode of behavior which may be expected to be advantageous to clients and to the public generally.

2. It must be assumed, we think, in the situations set forth in the questions submitted to this Committee by the National Conference of Lawyers and Certified Public Accountants, that each of the individual lawyers and certified public accountants who may be associated with each other, as employees or partners, will be a man of integrity who will scrupulously conform with the canons of ethics or rules of professional conduct of the profession of which he is a member.

3. Both the American Bar Association and the American Institute of Accountants maintain rules against advertising, solicitation, and division of fees with the "laity," a term

which in the view of each profession applies to members of the other.

4. It is well established that the unauthorized practice of law by a certified public accountant or any other individual not a lawyer would be illegal. In certain states in which regulatory public accounting legislation has been enacted it is illegal for a lawyer, if he is not licensed to do so, to practice as a public accountant. Even in states in which such legislation has not been enacted, it may be assumed that the legal profession generally would wish to discourage the "unauthorized practice of public accounting" by lawyers who were not qualified accountants.

5. The facts and assumptions set forth in the preceding four paragraphs permit responses to the three questions submitted to this Committee by the National Conference of Lawyers and Certified Public Accountants as follows:

Question A.

The employment of a lawyer on a salaried basis by a firm of certified public accountants, in itself does not raise any question of ethics or proper accounting practice, provided the lawyer as an employee of the accounting firm renders to clients of the accounting firm only services of a nature which the members of that firm are authorized to render. There is no provision of the by-laws or rules of professional conduct of the American Institute of Accountants which would require the certified public accountants employing the lawyer to forbid him to practice law as an individual in his own free time, or which would forbid them to grant a leave of absence from the accounting firm to serve clients of the accounting firm on legal matters. The members of the accounting firm could not participate in the fees for such services, and the lawyer should bill the client for such services independently of the accounting firm. We are not passing upon the desirability of such arrangements, but we do not consider them unethical.

Question B.

The employment by a law firm of a certified public accountant who might audit and certify financial statements under his own name for clients of the law firm who desired such service, in itself does not raise any question of ethics or proper accounting practice. It would be a violation of the rules of the American Institute of Accountants if such certified public accountant shared with his lawyer-employers the fees from such accounting services rendered by him to clients of the firm. There is no provision of the by-laws or rules of professional conduct of the American Institute of Accountants which would make it improper for the certified public accountant to render such accounting services to clients of the law firm on his own time, or on leave of absence, and to bill the client for such services independently of the law firm. We are not passing upon the desirability of such arrangements, but we do not consider them unethical.

Question C.

The rules of professional conduct of the American Institute of Accountants contain a provision prohibiting members from engaging in any business or occupation conjointly with the practice of public accounting, which is incompatible or inconsistent therewith. In response to specific inquiry this Committee has, in the past, expressed the opinion that the practice of law by a member of the Institute who was a member of the bar as well as a certified public accountant, would not be incompatible or inconsistent with the practice of public accounting. We are not passing upon the desirability of an individual carrying on the general practice of two professions simultaneously, but we do not consider such practice unethical. It must be recognized that in certain specialized branches of professional work, such as tax practice, in which questions of law and of accounting are frequently intermingled, an individual may combine the knowledge and skills of a lawyer and a certified public accountant with advantage to his client.

The questions whether a certified public accountant, who is also licensed to practice law, may go into partnership with a lawyer and continue as an individual to render professional accounting services to clients of the firm, or whether such an individual qualified to practice both professions may go into partnership with a certified public accountant and continue as an individual to practice law for clients of the firm, in themselves do not raise any questions of ethics or proper accounting practice. In either instance the dually qualified person must retain to himself the fees received for professional services performed by him as an individual which his partners are not authorized to render, and he may share with his partners only the fees from the services which they jointly are authorized to render. We are not passing upon the desirability of partnership arrangements between dually qualified persons and persons qualified only in one profession, but we do not consider such arrangements unethical.

Conclusion

Inasmuch as the rules of the American Bar Association and the American Institute of Accountants are similar with respect to fee-splitting, advertising, and solicitation, we

have not concerned ourselves, in answering the three questions submitted by the National Conference of Lawyers and Certified Public Accountants, with the possible utilization by an accountant of a law firm with which he may be associated as employee or partner, as a "feeder" for his accounting practice, or vice versa. Any attempt by a member of the Institute to evade existing rules through association with members of another profession could be dealt with quite readily under the provisions of Rule No. 15 of the rules of professional conduct of the American Institute of Accountants, which reads as follows:

> "(15) A member or an associate of the American Institute of Accountants engaged simultaneously in the practice of public accounting and in another occupation must in both capacities observe the by-laws and rules of professional conduct of the Institute."

In any case, we believe, such questions are of secondary importance in view of the primary justification for rules of professional conduct or ethics, that is, to safeguard the public interest. The compelling consideration, in our opinion, is the desirability of allowing the public complete freedom in the selection of lawyers or certified public accountants who the public believes can render most effectively the professional services it desires.

This reply has the unanimous approval of the five members of the Committee on Professional Ethics, but has not been passed upon by the Council of the American Institute of Accountants.

Yours truly,

COMMITTEE ON PROFESSIONAL ETHICS

John N. Aitken, Jr.
Frederick H. Hurdman
Lewis Lilly
C. Oliver Wellington
Donald M. Russell, *Chairman*
/s/ By Donald M. Russell

American Bar Association Committee on Professional Ethics and Grievances

OPINION NO. 272

(October 25, 1946)

Division of Fees—*Lawyer may not divide fees with an accountant, but may employ him on a salary to advise him but not his clients.*

Intermediaries—*Accountant employed by a lawyer independently certifying balance sheets for lawyer's clients.*

Conflicting Interests—*Lawyer also practicing accounting.*

Advertising, Direct & Indirect—*Lawyer holding out certified accountant as his employee.*

Candor & Fairness—*Lawyer using employee accountant to certify balance sheets would be required to disclose that he is such an employee.*

The chairman of the Unauthorized Practice Committee, at the instance of the National Conference of Lawyers and Certified Public Accountants, has submitted to the Committee, as well as to the Ethics Committee of the American Institute of Accountants, the following questions:

"1. Is it ethical for a firm of lawyers to employ a certified public accountant on a salaried or other compensatory basis, and permit the certified public accountant to prepare and certify financial statements under his own name as a C.P.A., for the use of the clients of the law firm? Does it make any ethical difference if the said services of the accountant are billed to the client separately, and the law firm participates in no way in the compensation received for the said accounting services? Does it make any ethical difference if, by leave of absence or other temporary arrangement, the law firm considers that the accountant renders the said services on his own time, and the accountant bills client independently?

"2. Is it ethical for a lawyer to be employed by a firm of accountants on a salaried or other compensatory basis, and to practice law for the clients of the accounting firm? Does it make any ethical difference if the services of the lawyer are billed to the client separately, and the accounting firm participates in no way in the compensation received for the legal services? Does it make any ethical difference if, by leave of absence or other temporary arrangement, the lawyer considers he is rendering the legal services on his own time, and the lawyer bills the client independently?

"3. Does *Opinion 269* make it unethical for a lawyer who is also a Certified Public Accountant to prepare and certify financial statements under his own name as Certified Public Accountant? Assuming that *Canon 33* and *Opinion 269* declare it unethical for him to go into partnership with an accountant and continue to practice law for the clients of a firm, is it ethical for him to go into partnership with a lawyer and continue to practice accountancy

for the clients of the firm? Does it make any difference if by billing separately or maintaining separate offices, or by any other method, he considers that the partnership has no interest in the accounting work?"

Canons 6, 22, 27, 33, 34 and 35

The opinion of the Committee was stated by MR. DRINKER, Messrs. Houghton, Jackson, Miller, Powell and Shackleford concurring. Mr. Hostetler was absent and did not participate.

In passing on the following questions the Committee does not, of course, undertake to pass on questions of law, statutory or otherwise, varying in the several states.

In every case where a lawyer performs services for a client which could be performed by one not a member of the bar, nevertheless, in performing them in the course of his legal services he is acting as a lawyer and subject to the Canons.

1(a) Is it ethical for a firm of lawyers to employ a certified public accountant on a salaried or other compensatory basis, and permit the certified public accountant to prepare and certify financial statements under his own name as a C.P.A. for the use of the clients of the law firm?

It is entirely ethical for a firm of lawyers to employ a public accountant (whether a C.P.A. or not) on a salaried basis to advise the law firm on matters of accounting and to assist the firm in connection with accounting problems arising in its law practice. For a law firm to employ an accountant on the basis of a division of the fees of the law firm would violate *Canon 34*, forbidding the division of legal profits or fees with those not lawyers. To permit such an accountant to certify statements under his own name as a C.P.A. for the use of clients of the law firm would violate the provision of *Canon 35* requiring the lawyer's relation to the client to be personal and direct, without the intervention of any lay intermediary.

In the course of a law suit, a corporate reorganization, the management of an estate or some other legal activity, it occasionally becomes necessary to have a balance sheet certified without the necessity of certification by an independent accountant.

A law firm could not furnish a certificate of a C.P.A. in its employ to a client for public use of the client without a disclosure in connection with the certificate that the C.P.A. was an employee of the law firm. However, we have frequently ruled that for a law firm to state publicly that it has in its employ a C.P.A. constitutes a violation of *Canon 27*. Accordingly, it would seem impossible for the law firm to furnish the statement specified without violating this Canon.

1(b) Does it make any ethical difference if the said services of the accountant are billed to the client separately, and the law firm participates in no way in the compensation received for the said accounting services?

Assuming, as the question does, that the services are performed for the client of the law firm as such, and that the accountant is known by the client as an employee of the law firm, the fact that the law firm does not participate in the compensation would, in our opinion, make no ethical difference.

1(c) Does it make any ethical difference if, by leave of absence or other temporary arrangement, the law firm considers that the accountant renders the said services on his own time, and the accountant bills client independently?

The relation of the law firm, the accountant and the clients contemplated by these questions, are, in our opinion, too close to be insulated by any such artificial arrangement.

2(a) Is it ethical for a lawyer to be employed by a firm of accountants on a salaried or other compensatory basis, and to practice law for the clients of the accounting firm?

The last paragraph of *Canon 33* is as follows:

"Partnerships between lawyers and members of other professions or non-professional persons should not be formed or permitted where any part of the partnership's employment consists of the practice of law."

Canon 35 provides:

"The professional services of a lawyer should not be controlled or exploited by any lay agency personal or corporate, which intervenes between client and lawyer. A lawyer's responsibilities and qualifications are individual. He should avoid all relations which direct the performance of his duties by or in the interest of such intermediary. A lawyer's relation to his client should be personal, and the responsibility should be direct to the client. * * *"

A lawyer may properly be employed by a firm of accountants on a salaried basis to advise the accounting firm, but such employment may, under no circumstances, be used to enable the accounting firm to render legal advice or legal services to its clients.

Should a lawyer be employed by a firm of accountants on the basis of receiving a percentage of the firm profits or fees, this would result in such close professional association between them as to be equivalent, for the purpose of *Canon 35*, to a partnership between them, and under our *Opinion 269* would

necessitate the subsequent confinement of the lawyer's activities to such as were permitted the lay accountants.

2(b) Does it make any legal difference if the services of the lawyer are billed to the client separately, and the accounting firm participates in no way in the compensation received for the legal services?

No such artificial device would, in our opinion, change the result.

2(c) Does it make any ethical difference if, by leave of absence or other temporary arrangement, the lawyer considers he is rendering the legal services on his own time, and the lawyer bills the client independently?

Our answer is the same as that to 2(b).

3(a) Does *Opinion 269* make it unethical for a lawyer who is also a Certified Public Accountant to prepare and certify financial statements under his own name as Certified Public Accountant?

The primary basis of *Opinion 269* was the express prohibition of *Canon 33* against partnerships between lawyers and laymen, as well as that of *Canon 34* forbidding a division of fees with laymen. The prohibition of *Canon 27* against advertising was involved only collaterally, there being no prohibition against advertising by laymen.

In the case of a lawyer who is also a C.P.A., *Canons 33* and *34* are not applicable.

The Committee all deem it in the interest of the profession and its clients that a lawyer should be precluded from holding himself out, even passively, as employable in another independent professional capacity. We find no provision in the Canons precluding a lawyer from being a C.P.A., or from using his knowledge and experience in accounting in his law practice.

We are all confident that a lawyer could not, as a practical matter, carry on an independent accounting business from his law office without violating *Canon 27*.

The Committee all agree that a lawyer, who is also a C.P.A., may perform what are primarily accounting services, as an incident to his law practice, without violating our Canons. We are also agreed that he may not properly hold himself out as practicing accounting at the same office as that in which he practices law, since this would constitute an advertisement of his services as accountant which would violate *Canon 27* as construed in our opinions.

The Committee is divided as to whether the Canons impliedly forbid a lawyer to practice accounting (including the certification of financial statements as an independent accounting activity) where this is done in accordance with our Canons and is not done for the purpose of feeding his law practice. A majority of the Committee are of the opinion that a lawyer, holding himself out as such, may not also hold himself out as a certified public accountant at any office without violating *Canon 27*, because his accounting activities will inevitably serve as a feeder of his law practice. A minority of the Committee, while agreeing that, as a practical matter, a lawyer could not properly carry on a considerable accounting practice and keep it independent of his law practice or avoid other violations of the Canons, nevertheless, find nothing in the Canons which precludes a lawyer from attempting to carry on both professions, wholly independent of one another, at the same time but from a different office with different stationery and where in practicing accounting the lawyer follows all the Canons pertaining to lawyers.

3(b) Assuming that *Canon 33* and *Opinion 269* declare it unethical for him to go into partnership with an accountant and continue to practice law for the clients of a firm; is it ethical for him to go into partnership with a lawyer and continue to practice accountancy for the clients of the firm?

The answer to this is covered by that to 3(a).

3(c) Does it make any difference if by billing separately or maintaining separate offices, or by any other method, he considers that the partnership has no interest in the accounting work?

The method of carrying on the work or of billing for accounting services would be material only as indicating or negativing the conclusion that they were carried on primarily to advertise or as a feeder to the law practice.

THE OLIVER BILL

For the information of our members and readers, there is reproduced below,

1. the text of the Oliver bill, approved by Governor Dewey on March 25, 1947, to become Chapter 340 of the Laws of 1947;
2. the text of Governor Dewey's memorandum which accompanied his approval of the bill; and
3. the text of the Society's position in opposition to this bill, as transmitted in the letter to Governor Dewey over the signature of Prior Sinclair, President, on March 19, 1947.

STATE OF NEW YORK
No. 2921—INT. 2523
IN SENATE
March 7, 1947

Introduced by COMMITTEE ON RULES—(at request of Mr. OLIVER)—read twice and ordered printed, and when printed to be committed to the Committee on Finance

AN ACT

To amend the education law, in relation to granting certified public accountant certificates on the basis of experience

The People of the State of New York, represented in Senate and Assembly, do enact as follows:

Section 1. Section fourteen hundred ninety-two of chapter twenty-one of the laws of nineteen hundred nine, entitled "An act relating to education, constituting chapter sixteen of the consolidated laws," as amended by chapter one hundred forty of the laws of nineteen hundred ten, such section having been added by chapter two hundred sixty-one of the laws of nineteen hundred twenty-nine, is hereby amended to read as follows:

§ 1492. Certified public accountants. The certificate of certified public accountant shall be issued, upon application to the department and the payment of a fee to be fixed by the department, which fee is to accompany the application, to any citizen of the United States, or to any person who has declared his intention of becoming such citizen, who resides within the state or has a place for the regular transaction of business therein, who is twenty-one years of age or over and of good moral character, who submits evidence satisfactory to the department of the possession of academic and professional qualifications for the public practice of accountancy and who passes the examination required by the department; *provided, however, that in lieu of the requirements as to education and examination herein the department may accept, in the case of applicants who have reached the age of forty years, evidence of fifteen years' experience in the intensive application of accountancy principles and auditing procedures satisfactory to the state board of certified public accountant examiners, subject to review by the commissioner of education;* provided *further*, that the certificate of certified public accountant issued to any person who has declared his intention of becoming a citizen of the United States shall become void at the expiration of eight years from the date of the declaration of the intention of such applicant to become a citizen, unless prior to the expiration of said eight years evidence is furnished to the department that the applicant has become a citizen of the United States.

§ 2. This act shall take effect immediately.

EXPLANATION—Matter in *italics* is new; matter in brackets [] is old law to be omitted.

STATE OF NEW YORK
EXECUTIVE CHAMBER
ALBANY
March 24, 1947

MEMORANDUM filed with Senate Bill, Introductory Number 2523, Printed Number 2921, entitled:

"AN ACT to amend the education law, in relation to granting certified public accountant certificates on the basis of experience"

Approved

Concerning this measure, the State Education Department has written as follows:

"This bill provides that in lieu of the requirements as to education and examination as prerequisite for licensure in the field of certified public accountancy, the Department may accept, in the case of applicants who have reached the age of forty years, evidence of fifteen years experience in the intensive application of accountancy principles and auditing procedures satisfactory to the State Board of Certified Public Accountant Examiners, subject to review by the Commissioner of Education.

"The Board of Regents and the Department recognize that there is some justice in this proposal. There are a number of men over forty years of age and who over a period of fifteen years or more have achieved distinction in the intensive application of accountancy principles and auditing procedures. Only those who have reached such levels of achievement should receive consideration under this proposed law. It should not be permitted to favor those who have attempted unsuccessfully to secure license by examination or who have only an average record of performance, even though they have been in the practice of accountancy for fifteen or more years.

"The bill should be approved only on the assumption that the Department of Education would be expected to formulate rigid standards for the guidance of the Board of Certified Public Accountant Examiners in the administration of the proposed law. Under these conditions and in view of the discretionary power given to the Board of Certified Public Accountant Examiners and the Commissioner of Education, the Deartment believes that the welfare of the public can be protected if this bill becomes law."

This bill can be appoved solely on the assurance by the Education Department that

the powers granted by this bill will be used only in exceptional cases. If, after a year's experience, the Department and the Board of Examiners find this law unworkable or too loose, it can and should be modified or repealed. The high standards of public accountancy in New York, which led the Nation in establishing such standards, must not be lowered.

The bill is approved.

(signed) THOMAS E. DEWEY.

TEXT OF SOCIETY'S POSITION IN OPPOSITION TO THE OLIVER BILL

in letter to Governor Dewey, dated March 19, 1947.

"On behalf of this Society I wish to register opposition to the Oliver Bill. This bill would dispense entirely with educational requirements, experience in the field of public accountancy and examinations.

"The proposed amendment would lower the standards for the issuance of a certified public accountant certificate which heretofore have never been lowered by the legislature since the first C.P.A. law was passed fifty years ago.

"A certified public accountant certificate is not necessary for the practice of public accountancy in this state. Unlike the medical, dental, legal, and some other professions, any person may practice public accountancy and call himself a public accountant. Persons eligible to apply under the proposed amendment are not, under the present law, prohibited from engaging in the practice of public accountancy. For fifty years, only those who have passed the C.P.A. examination and met the other requirements as set forth in the law have been entitled to call themselves certified public accountants.

"In the last fifty years over eleven thousand certificates have been issued to certified public accountants who have met the required educational and experience qualifications and who have taken and passed the examinations.

"The certified public accountant is recognized by bankers, creditmen, and others concerned with financial statements, as a professional man who has met the standards of education and training. It is a matter of public knowledge that under present and past laws, a person became entitled to the designation of C.P.A. only after the completion of the prescribed educational and experience requirements and of examination. Therefore the issuance of the C.P.A. certificate without a prescribed education (or its equivalent) and without examination, as proposed in the Oliver Bill, would in fact create two classes of certified public accountants without distinguishing titles.

"It is our opinion that if the Oliver Bill is signed by you and becomes law that within a short period of time many thousands lacking the qualifications to properly serve the public would apply for and be entitled to C.P.A. Certificates. The granting of such certificates would foster public misunderstanding and confusion, if not deceit.

"We respectfully urge that the Oliver Bill (Senate Introductory No. 2523, Print No. 2921) be vetoed.

"Respectfully yours,

(signed) PRIOR SINCLAIR,
President.

REVISION OF TEXT OF BERCU DECISION

Mr. Mathias F. Correa, of Cahill, Gordon, Zachry & Reindel, Esqs., counsel to the Society in the *Matter of New York County Lawyers' Association* v. *Bernard Bercu*, has just informed us that Mr. Justice Shientag has revised and republished subdivision 4 of his opinion in the above entitled matter, so as to delete the dictum therein contained with respect to architects and their profession.

In order that members who have heretofore received printed copies of the original decision may correct their copies, the corrected text of the first five paragraphs of subdivision 4 of the opinion is reproduced herewith:

"4.

"From this point, I shall assume for the purposes of this case, without so deciding, that the Penal Law provisions are broad enough to cover "any practice of law", by an individual layman. (Cf. *People* v. *Goldsmith*, 249 N. Y. 586; *Bennett* v. *Goldsmith*, 280 N. Y. 529; Report of the Attorney General [1916] 455, 481-482). I shall even assume *arguendo* that the courts have inherent power to define what shall constitute the unlawful practice of law.

"Keeping the foregoing assumptions in mind, was the respondent Bercu, in rendering the services which have been described, illegally practicing law?

"A realistic approach must be made to a solution of this phase of the problem. The accountant, when he prepares an income tax report, has to be familiar with the Income Tax Law, the decisions of the courts relating thereto and the rulings of the administrative agency which is in charge of enforcement.

"Clearly, when he is pursuing his specialized calling, he has to be in a position to advise clients on matters that involve the law and are directly applicable to the work he is called upon to do. Merely because an accountant gives advice which may ultimately

lead to litigation and impliedly prophesies the outcome of that litigation, it does not follow that he is illegally practicing law. The question, so far as the accountant is concerned, is whether the advice that is given deals primarily with proper accounting practice under the Income Tax Law. In the interpretaion of that statute, accounting and legal concepts are so intermingled that it is difficult, if not impossible at times, to separate or to distinguish one from the other.

"True it may be said that when an accountant prepares an income tax return, he is engaged primarily in the work of his profession, and any matter of law which directly arises in connection with his specialized functions is dealt with only incidentally. True it is, also, that even in such cases, questions of law may arise in connection with the work that is being done, which would plainly be within the exclusive competence of the lawyer. It would not be suggested, for example, that an accountant, drawing up an income tax return, may lawfully pass on questions of law such as domicile, the validity of a marriage, the construction of a will, a deed of trust, or any other legal document, upon which tax liability may on occasion depend. Even in connection with his actual preparation of an income tax return a certified public accountant, not himself a lawyer, may not lawfully perform research work for his client or give him advice on any problem involving a knowledge of law, which is aside from the tax law itself. The respondent Bercu limited his research and his advice to principles of proper accounting, to a study of the tax law, the court decisions and the department rulings on the specific subject with which he was concerned. He did not go outside the tax law; he did not inquire into any other law.

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